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TRANSCRIPT OF RECORD

Supreme Court of the United States

OCTOBER TERM, 1942.

No. 675

THE DETROIT EDISON COMPANY, PETITIONER,

vs.

COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SIXTH CIRCUIT

PETITION FOR CERTIORARI FILED JANUARY 26, 1943.

CERTIORARI GRANTED MARCH 1, 1943.

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BEFORE UNITED STATES BOARD OF TAX APPEALS

Docket No. 103379

THE DETROIT EDISON COMPANY, Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE, Respondent

APPEARANCES:

For Taxpayer: Edward H. Green, Esq., Harvey A. Fischer, Esq.

For Commissioner: Paul A. Sebastian, Esq.

DOCKET ENTRIES

1940

June 18—Petition received and filed. Taxpayer notified. (Fee paid).

June 13—Copy of petition served on General Counsel.

June 13—Request for circuit hearing in Detroit, Michigan, filed by taxpayer.

June 27—Notice of appearance of Harvey A. Fischer, as counsel for taxpayer, filed.

Aug. 9—Answer filed by General Counsel.

Aug. 13—Copy of answer served on taxpayer, Detroit, Mich.

1941

Feb. 19—Hearing set April 7, 1941, Detroit, Mich.

Apr. 14-16—Hearing had before Mr. Smith on the merits. Stipulation of facts to be received in Washington. Briefs due June 16, 1941; Reply briefs due July 5, 1941—Exchange.

Apr. 23—Stipulation of facts filed.

May 19—Transcript of hearing 4/14 & 16/41 filed.

[fol. 2] June 10—Brief filed by taxpayer.

June 16—Brief filed by General Counsel.

June 19—Copy of brief served on General Counsel.

July 3—Reply brief filed by taxpayer. 7/3/41 copy served on General Counsel.

Oct. 14—Opinion rendered, Smith, Div. 5. Decision will be entered for the respondent. 10/14/41 copy served.

Oct. 14—Decision entered, Arundell, Div. 7.

1942

Jan. 10—Supersedeas bond in the amount of $21,000.00 approved and ordered filed.

Jan. 10—Petition for review by United States Circuit Court of Appeals, Sixth Circuit, filed by taxpayer.

Jan. 10—Statement of points to be relied on filed by taxpayer.

Jan. 10—Præcipe for record filed by taxpayer.

Jan. 10—Designation of contents of record filed by taxpayer.

Jan. 13.—Proof of service of petition for review and statement of points filed.

Jan. 22—Counter designation of contents of record filed by General Counsel.

Jan. 30—Proof of service of counter-designation of contents of record filed by General Counsel.

BEFORE UNITED STATES BOARD OF TAX APPEALS

PETITION—Filed June 13, 1940

Now comes The Detroit Edison Company, a New York corporation, the Petitioner herein, and hereby files this, its Petition for the redetermination of the deficiency of $10,298.98 for the calendar years 1936 and 1937, (inclusive), as determined by the Commissioner of Internal Revenue in his Notice of Deficiency bearing date of April 26, 1940, and Bureau Symbols SN-IT-1, and as a basis for this proceeding, alleges as follows:

[fol. 3] First: That the Petitioner is a corporation, organized and existing under and by virtue of the laws of the State of New York, with its principal office for the transaction of its corporate business at 2000 Second Avenue, Detroit, Michigan.

Second: The Notice of Deficiency, a copy of which is annexed hereto, marked Exhibit "A", (by reference incorporated in and made a part of this Petition), was mailed to the Petitioner on or after April 26, 1940.

Third: The taxes in controversy, and covered in the deficiency letter, (Exhibit "A"), are income taxes for the calendar years 1936 and 1937 inclusive, the sum total of which is $10,298.98.

Fourth: In determining the foregoing deficiency, the Commissioner, (Respondent), committed the following errors:

(a) The Respondent erred in finding and ruling that the Petitioner's depreciation base for the calendar year 1936 should be decreased in the amount of $1,166,712.77.

(b) The Respondent erred in finding and ruling that the Petitioner was not entitled to the benefit of depreciation upon the sum of $1,166,712.77, for the calendar year 1936 in the sum of $40,273.11.

(c) The Respondent erred in finding and ruling that the Petitioner's depreciation base for the calendar year 1937 should be decreased in the amount of $1,208,496.01.

(d) The Respondent erred in finding and ruling that the Petitioner was not entitled to the benefit of depreciation upon the sum of $1,208,496.01 for the calendar year 1937 in the sum of $41,786.26.

Fifth: The facts upon which this Petitioner relies as the basis for this proceeding are as follows:

(a) The sum of $1,166,712.77 by which the Petitioner's depreciation base for the calendar year 1936 was erroneously decreased by the Respondent, represents cash expended by the Petitioner in the acquisition of tangible depreciable property used in its business.

(b) The sum of $1,208,496.01 by which the Petitioner's depreciation base for the calendar year 1937 was erroneously decreased by the Respondent, represents cash ex-
[fol. 4] pended by the Petitioner in the acquisition of tangible depreciable property used in its business.

(c) The Petitioner was entitled to a deduction for depreciation in the year 1936 on the said sum of $1,166,712.77; depreciation thereon at rates which have been approved by the Respondent, amounted to $40,273.11, and Respondent has erroneously reduced the depreciation claimed by the Petitioner for the year 1936 by that amount.

(d) The Petitioner was entitled to a deduction for depreciation in the year 1937 on the said sum of $1,208,496.01; depreciation thereon at rates which have been approved by the Respondent amounted to $41,786.26, and Respondent has erroneously reduced the depreciation claimed by the Petitioner for the year 1937 by that amount.

Wherefore, the Petitioner prays that this Board may hear the proceedings, and set aside the deficiency proposed by the Respondent, and correct the errors made by the Respondent, as herein complained of.

The Detroit Edison Company. By A. C. Marshall, President.

Edward H. Green, Attorney for Petitioner. Business Address: No. 48 Wall Street, New York, New York; Oscar C. Hull, Attorney for Petitioner. Business Address: 1101-14 Dime Building, Detroit, Michigan; Harvey A. Fischer, Attorney for Petitioner. Business Address: 1101-14 Dime Building, Detroit, Michigan.

(Duly verified).

[fol. 5] EXHIBIT "A" TO PETITION

Treasury Department

Internal Revenue Service

Detroit, Michigan

555 Federal Building
IT:CONF.

April 26, 1940.

The Detroit Edison Company,
2000 Second Avenue,
Detroit, Michigan.

Collection District: Michigan.

SIRS:

You are advised that the determination of your income tax liability for the taxable years 1936 and 1937 discloses a deficiency of $10,298.98 as shown in the statement attached.

In accordance with the provisions of existing internal revenue laws, notice is hereby given of the deficiency mentioned.

Within 90 days (not counting Sunday or a legal holiday in the District of Columbia as the 90th day) from the date of the mailing of this letter, you may file a petition with the United States Board of Tax Appeals for a redetermination of the deficiency.

Should you not desire to file a Petition, you are requested to execute the enclosed form and forward it to Internal

Revenue Agent in Charge, Detroit, Michigan, for the attention of IT: CONF. The signing and filing of this form will expedite the closing of your returns by permitting an early assessment of the deficiency, and will prevent the accumulation of interest, since the interest period terminates 30 days after filing the form, or on the date assessment is made, whichever is earlier.

Respectfully, Guy T. Helvering, Commissioner, By Geo. E. Neal, Internal Revenue Agent in Charge.

Enclosures: Statement. Form of Waiver.

[fol. 6] Statement

IT:CONF.

The Detroit Edison Company
2000 Second Avenue
Detroit, Michigan.

Tax Liability for Taxable Years Ended December 31, 1936 and 1937

Income Tax

Years	Liability	Assessed	Deficiency
1936	$1,074,080.40	$1,070,049.36	$4,031.04
1937	1,330,487.12	1,324,219.18	6,267.94
	$2,404,567.52	$2,394,268.54	$10,298.98

In making this determination of your income tax liability, careful consideration has been given to the report of examination dated April 15, 1938, January 5, 1939 and April 22, 1939; to your protest dated May 3, 1939 and to the statements made at conferences held on January 15, 1940, January 16, 1940, February 13, 1940 and February 14, 1940, March 6, 1940 and March 12, 1940.

A copy of this letter has been mailed to your representative, Mr. Harvey A. Fischer, 1104 Dime Bank Building, Detroit, Michigan, in accordance with authority contained in a power of attorney executed by you and on file in the Bureau.

1936

Adjustments to Net Income

Net income as disclosed by return		$7,178,479.31
Unallowable Deductions and Additional Income:		
(a) Contributions	$5,775.00	
(b) Bad debt recoveries	28,310.73	
[fol. 7]		
(c) Social Security taxes	1,462.78	
(d) Legal expense	933.00	
(e) Profit on sale of stock to employees	3,219.84	
(f) Fees	2,100.00	
(g) Excessive depreciation	40,273.11	
(h) Bad debts	115.55	
(i) Capital expenditures	1,431.55	
		83,621.56
Total		$7,262,100.87
Non-taxable Income and Additional Deductions:		
(j) Capital stock tax accrual	56,491.00	
(k) Amortization of bond discount, expenses	166.98	
		56,657.98
Net income as adjusted		$7,205,442.89

Explanation of Adjustments

(a) During the year 1936 you made contributions to the Committee of Public Utility Executives, in Washington, D. C. in the amount of $5775.00 and claimed such amount as a deduction under miscellaneous general expenses.

The above contributions are in the nature of donations not deductible as defined under Section 23 (q) of the Revenue Act of 1936.

(b) The following accounts with Municipalities were written off and claimed as a deduction from gross income for

1935, were recovered in part and balances reinstated during 1936.

[fol. 8] Livonia Township, collection		$503.20
Accounts reinstated—		
Livonia Township	$15,198.02	
Harrison Township	8,174.00	
Garden City	4,435.51	
		27,807.53
Total recovery		$28,310.73

Article 42-1 Regulation 94 relating to the Revenue Act of 1936 states—

"Bad debts or accounts charged off subsequent to March 1, 1913 because of the fact that they were determined to be worthless, which are subsequently recovered, whether or not by suit, constitute income for the year in which recovered, regardless of the date when the amounts were charged off."

Since the above accounts were charged off subsequent to March 1, 1913 because they were determined to be worthless, and they now have been collected or reinstated they constitute income for the year 1936.

(c) Social Security taxes accrued	$162,241.30
Social Security taxes accruable	$160,778.62
Excess Accrual	$1,462.68

(d) You claimed a deduction for legal expense in the amount of $933.00 incurred in connection with exchange of property between your corporation, Chrysler Corporation and the Detroit Terminal Railroad Company.

In accordance with Article 24-2 of Regulations 94, the cost of defending or perfecting title to property constitutes a part of the cost of the property and is not a deductible expense.

[fol. 9] (e) During the year 1936 you sold 1876 shares of your own capital stock to employees, under a stock purchase plan, for $160,327.62, the stock having been acquired by you in the open market at a cost of $157,107.78, thereby realizing a profit of $3219.84. See Exhibit "A" for details.

In accordance with G. C. M. 16651, published in Cumulative Internal Revenue Bulletin XV-2, July-December 1936, page 130, profits realized upon the sale of a company's own capital stock to its employees under a stock purchase plan, the stock having been acquired by the company in the open market, constitute taxable income.

(f) The deduction of $2100.00 for fee paid to the Securities and Exchange Commission for the registration of Series "G" bonds has been disallowed in accordance with IT 3026 published in Cumulative Internal Revenue Bulletin XV-2, July-December 1936, page 83, which states that the fee paid to the Securities and Exchange Commission for registration of securities is not deductible in computing net income inasmuch as the amount is a capital expenditure.

Since the fee paid applies to a specific series of bonds the amount is to be amortized over the life of such bonds. See Exhibit "B" attached.

(g) From time to time you receive applications for the extension of your transmission lines to places which, in your opinion, are too far removed from existing transmission lines to warrant capital expenditures necessary to serve such applicants. You will, however make the necessary capital expenditures required in the construction of a line extension upon the payment by the applicant for such services of a certain sum as fixed by you. It is then agreed in writing to thereafter extend service to the premises to be served by the line extension under the rules and regulations promulgated by the Michigan Public Service Commission.

In the past contributions were required from the applicants for electric service, ranging from $1500.00 per mile to $500 per mile, dependent upon a number of varying [fol. 10] factors. The amounts contributed by the applicant do not in all cases represent actual total cost of constructing the required line extension but rather in some cases only a part of said cost, the amount to be charged to the contributor being determined by you. In other cases the amount contributed by the consumer does represent the total cost of the extension line. The amount paid by the applicant in either case is final and no adjustment is made thereafter except in those cases where the contract provides that at the end of a calendar year during which the line shall have been built the company shall refund to the customer or his assignees an amount equal to one-half of the company's revenues from the said line from the time the

line was built to the end of the calendar year, and that at the end of each of the succeeding five calendar years the company shall similarly refund to the consumer or his assignee one-half of the revenues from said line for that year, provided that the aggregate amount of said refund shall not exceed such amount as may be mutually agreed upon and expressly stated in the contract. These contracts further provide that no refund shall be made on the basis of revenues derived from the said line after the expiration of the fifth calendar year following the calendar year in which the line is completed.

Upon the completion of any particular line extension you enter upon your books as a property item the full cost of the line extension including labor and material, and you do not subtract therefrom the amount of given contribution. Depreciation is taken upon your books and on the return, upon the basis of the full cost of the line extension without giving any effect to the amounts received as contributions from prospective users of electric current.

Depreciation has been disallowed for the years 1936 and 1937 in the respective amounts of $40,273.11 and $41,786.26. It is the position of the Government that to the extent of amounts received from your customers under certain contracts in aid of construction of extension lines [fol. 11] and for which the customer is entitled to no refund, and to the extent of the unrefunded balances forfeited by your customers under certain other contracts providing for refunds within a certain limited period of time, said amounts represent reimbursements of capital expenditures made to your corporation in the construction of said extension lines.

The unrefunded balances of aids in construction for the calendar years ended December 31, 1935 and December 31, 1936 have been determined in the respective amounts of $1,148,679.86 and $1,184,745.67, or an average reduction in your depreciable base for the calendar year 1936 in the amount of $1,166,712.77 on which depreciation has been disallowed as follows:

Average Depreciable Base	Rate	Depreciation Amount
$1,146,010.89	3.4604	$39,656.56
19,409.84	3.0104	584.31
1,292.04	2.4951	32.24
$1,166,712.77		$40,273.11

The unrefunded balances of aids in construction for the calendar years ended December 31, 1936 and December 31, 1937 have been determined in the respective amounts of $1,184,745.67 and $1,232,246.34, or an average reduction in your depreciable base for the calendar year 1937 in the amount of $1,208,496.01, on which depreciation has been disallowed as follows:

Average Depreciable Base	Rate	Depreciation Amount
$1,187,562.04	3 4661	$41,162.09
19,641,93	3.0137	591.95
1,292.04	2.4940	32.22
$1,208,496.01		$41,786.26

[fol. 12] In acquiring the net assets of Michigan Electric Power Company in 1935, deposits in closed banks were taken over at 31.45% of book value.

(h) Loss of deposit in Commercial Bank of Mayville in the amount of $367.40 is reduced by portion of discount applicable thereto. 31.45% of 267.40—$115.55.

(i) Cost of certain items of equipment purchased during the year 1936 was charged to expense as follows:

Kompak Air Filler	$1,006.96
Automatic Stoker	249.50
Unit Heater and Speed Controller	175.10
Total	$1,431.55

Section 24 of the Revenue Act of 1936 provides, in part, as follows:

(a) "General rule.—"In computing net income no deduction shall in any case be allowed in respect of—

(2) "Any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate;"

Inasmuch as the above items represent amounts paid out for permanent improvements they cannot be claimed as a deduction in computing net income. Hence your income has been increased in the amount of $1431.55.

(j) Capital stock tax deductible	$139,573.00
Capital stock deducted	83,082.00
Additional deduction	$56,491.00

The adjustment for the capital stock taxes for the year ended June 30, 1936 was made in connection with the audit of the return for the taxable year ended December [fol. 13] 31, 1935 as the deduction was properly accruable in the latter year.

(k) This adjustment is made to correct allowance for amortization of bond discount and expense as follows:

Expense amortized as per books:		
Series "C"	$ 2,838.06	
Series "D"	34,802.16	
Series "E"	33,704.64	
Amortized expense		$71,344.86
Net premium amortized as per books:		
Series "F"	20,314.89	
Series "G"	4,720.17	25,035.06
Amortized Income		$46,309.80
Allowable amortization, as corrected in Exhibit "B" attached		46,502.18
Difference		$ 192.38
Less: Difference between premium and redemption expense on series "C" bonds amortized per books	$14,116.96	
and amount allowance on return	14,091.56	25.40
Net adjustment		$ 166.98

Computation of Tax

Income Tax		
Net income for normal tax computation		$7,205,442.89
Less: Interest on U. S. Obligations	$20,192.98	
Dividends received credit	16,980.57	37,173.55
Normal tax net income		$7,168,269.34

[fol. 14]

8% of $2000.00 (Over 0 to $200)	160.00
11% of $13,000 (Over $200 to $15000)	1,430.00
13% of $25,000 (Over $15,000 to $40,0000)	3,250.00
15% of $7,128,269.34 (Over $40,000)	1,069,240.40
Total normal tax assessable	$1,074,080.40
Income tax assessed (normal tax and surtax) Original June list, Account No. 405608	1,070,049.36
Deficiency of income tax	$ 4,031.40

1937

Adjustments to Net Income

Net income as disclosed by return	$8,223,746.63
Unallowable Deductions and Additional Income:	
(a) Estimated final loss in closed bank	$381,876.10
(b) Federal capital stock tax accrual	15,010.48
(c) Loss due to abandonment of Delray Power House #2	140,294.04
(d) Cost of splicing cable at Delray Cable Plant	37,172.95
(e) Excess accrual for Federal Unemployment	2,063.56
(f) Loss claimed due to liquidation of subsidiary corporation	47,670.27
(g) Taxes paid for Delray Terminal Railway Company	1,534.56
(h) Depreciation on contributed properties	41,786.26
	667,408.22
Total	$8,891,154.85

[fol. 15] Non-taxable Income and Additional Deductions:	
(i) Depreciation on capital expenditures	143.16
(j) Adjustment to amortization of bond discount and expense	6,214.01
	6,357.17
Net income as adjusted	$8,884,797.68

1937

Explanation of Adjustments

Items (a), (b), (c), (d), (e), (f), (g), (i) and (j) have been agreed to.

(h). See item (g) for 1936.

Computation of Tax

Net income for normal tax computation	$8,884,797.68
Less:	
Dividends received credit	7,150.24
Normal tax net income	8,877,647.44
8% of $2000.00 (over 0 to $2000)	160.00
11% of 13000.00 (over $2000 to $15,000)	1,430.00
13% of 25000.00 (over $15,000 to $40,000)	3,250.00
15% of 8,837,647.44 (over $40,000)	1,325,647.12
Total normal tax assessable	$1,330,487.12
Income tax assessed (Normal tax and surtax):	
Original Sept. list, Account No. 405702-1	231,329.46
Additional April 12, 1940 list, Account No. 529003	92,889.72
	1,324,219.18
Deficiency of income tax	$ 6,267.94

[fol. 16] EXHIBIT "A"

Gross Profit on Shares of Reacquired Stock of the Detroit Edison Company Issued to Employees During the year 1936

	Shares	Amount
Option price to Employes of Reacquired Stock issued during the year 1936 (Exhibit N-1)	1,876	$160,327.62
Less: Cost to The Detroit Edison Company of Reacquired Stock which was issued to Employes during the year 1936	1,876	157,107.78
Gross Profit on shares of stock issued to Employes during the year 1936		$ 3,219.84

EXHIBIT "A-1" TO PETITION

Option Price of Reacquired Stock of the Detroit Edison Company Issued to Employes During Year 1936

	J.E.	Number of Shares	Option Price
January	108	162	$13,894.48
February	89	166	14,645.51
March	187	203	14,988.94
April	154	261	19,402.12
May	81	118	10,197.17
June	91	420	32,080.41
July	107	135	11,893.59
August	110	100	8,518.75
September	187	109	12,044.44
October	81	106	12,429.65
November	105	33	3,387.01
December	180	63	6,845.55
Total		1,876	$160,327.62

(Here follows 1 paster, Exhibit "B", folios 17-18)

[fol. 17-18]
The Detroit Edison Company
IT:Conf.

EXHIBIT "B" TO PETITION

Amortization of Bond Discount and Expense on General Refunding Mortgage Gold Bonds as Corrected

Series	Date of Issue	Date of Maturity	Amount of Issue	Unamortized Balances As Adjusted 12/31/35	Unamortized Balances Current Issue	Additions	Number of Months to Maturity	Allowable Amortization Per month	Allowable Amortization 1936	Unamortized Balances December 31, 1936 Redeemed	Unamortized Balances December 31, 1936 Remainder
C	8/1/26	8/1/62	$20,000,000 00	$100,593 54			319	$ 315 34	$ 2,838 06	$97,755 48	
D	2/1/31	2/1/61	50,000,000 00	872,954 97			301	2,900 18	34,802 16		$838,152 81
E	10/1/32	10/1/52	15,000,000 00	564,553 57			201	2,808 72	33,704 64		530,848 93
F	10/1/35	10/1/65	49,000,000 00	(634,126 84)		$37,997 67	357	(A)	(20,314 89)		(575,814 28)
E	"	"	—0—	5,029 24			357	14 0875	169 05		4,860 19
G	9/1/36	9/1/66	20,000,000 00	—0—	($546,778 03)		360	(B)	(4,720 17)		(542,057 86)
G	"	"	—0—	—0—		2,100 00	360	5,833			
								(C)	23 33		2,076 67
	TOTALS			$909,004 48	($546,778 03)	$40,097 67			$46,502 18	$97,755 48	$258,066 46

(a) Computed monthly on basis of new additions during year.
(b) Computed monthly over four month period.
(c) Period of four months.

[fol. 19] BEFORE UNITED STATES BOARD OF TAX APPEALS

ANSWER—Filed August 9, 1940

Comes now the Commissioner of Internal Revenue, by his attorney, J. P. Wenchel, Chief Counsel, Bureau of Internal Revenue, and for answer to the petition filed herein, admits and denies as follows:

First, Second and Third. Admits the allegations contained in paragraphs, First, Second and Third of the petition.

Fourth (a) to (d), inclusive. Denies that the Commissioner erred as set forth in subparagraphs (a) to (d), inclusive, of paragraph Fourth of the petition.

Fifth (a) to (d), inclusive. Denies the allegations of fact contained in subparagraphs (a) to (d), inclusive, of paragraph Fifth of the petition.

Sixth. Denies generally and specifically each and every allegation contained in the petition not hereinbefore specifically admitted, qualified or denied.

Wherefore, it is prayed that the Commissioner's determination be approved.

(Signed) J. P. Wenchel, P.M.C., Chief Counsel, Bureau of Internal Revenue.

Of Counsel:

DeWitt M. Evans, Division Counsel; Paul A. Sebastian, Special Attorney, Bureau of Internal Revenue.

PAS/CH/8/5/40

BEFORE UNITED STATES BOARD OF TAX APPEALS

STIPULATION OF FACTS—Filed April 23, 1941

The parties hereto, through their respective attorneys of record, hereby stipulate that the following facts are true and may be received in evidence without further proof thereof, each party, however, reserving the right to object [fol. 20] to the admissibility of any of the facts so stipulated on the ground of materiality or relevancy, and each party further reserving the right to introduce other evidence not inconsistent with the facts herein stipulated.

(1) The Petitioner is a corporation organized and existing under and by virtue of the laws of the State of New York, but duly admitted and licensed to do business in the State of Michigan.

(2) The Petitioner is a Public Utility Corporation engaged among other things, in the generation and sale of electric energy in the City of Detroit, Michigan, and surrounding territory, (but entirely within the State of Michigan), and operates under the jurisdiction of the Michigan Public Service Commission.

(3) The Petitioner in connection with the distribution and sale of electric energy, from time to time receives applications for the extension of its transmission and/or distribution lines to places which in the opinion of the Petitioner are situated too far from existing transmission and/or distribution lines to warrant the expenditure of amounts necessary to serve such applicants for service.

(4) Upon payment by the applicant of a sum fixed by the Petitioner, the latter agrees in writing to make the necessary expenditures required in the construction of a line extension. The agreement between the Petitioner and each applicant is evidenced by one of five types of agreements which are annexed hereto and marked Exhibits 1, 2, 3, 4 and 5.

(5) The Petitioner has from time to time required the applicant to pay varying sums ranging from $500.00 per mile to $1,500.00 per mile of line extension. These amounts as fixed by the contracts represent the estimated cost per mile of line construction.

(6) The amount of the payment made by the applicant is the estimated cost, and not the actual cost, but it never exceeds the actual cost of constructing the requested line extension, and no increase or decrease is made in the amount fixed in the contract upon the completion of the line [fol. 21] extension by reason of the actual cost thereof. The amount paid by the applicant is in all cases final as to such applicant. The applicant may however, in accordance with the Agreement in writing, providing for refunds, become entitled to receive all or part of such payment upon the happening of the events provided for therein.

(7) The material and property used in the construction of the line extension and the cost of labor, is in all cases paid from the general working funds of the Petitioner. The records of the Petitioner set forth and identify all work performed and to be performed under the provisions of any given contract.

(8) Upon the completion of the line extension, the Petitioner in accordance with standard practice enters upon its books as a "property item", (such as poles, lines etc.) the cost of the line extension, including labor and material, and does not substract from that sum the amount of the payment made by the applicant.

(9) Depreciation is claimed by the Petitioner for income tax purposes for the years 1936-1937 upon the cost to the Petitioner thus arrived at, at rates approved by the Commissioner.

(10) The cash payment made by the applicant in those contracts providing for refunds, is not earmarked for the building of any given line extension, but upon its receipt becomes a part of the free working capital of the Petitioner. The cash account is debited for the full amount of the payment, and a like amount is credited to a liability account entitled, "Customers' Deposits for Line Extensions", classified under Account No. 261, "Miscellaneous Unadjusted Credits" as required by the Uniform Classification of Accounts for Electric Utilities prescribed by the Michigan Public Utilities Commission, (now known as Michigan Public Service Commission). After the expiration of the period during which refunds may be made to the customers under the terms of the written contract pursuant to which a line extension has been constructed, the Petitioner is [fol. 22] then required by Account No. 255 to transfer the unrefunded balance, if any, from Account No. 261 "Miscellaneous Unadjusted Credits" to Account No. 255, which reads as follows:

"255. Contributions for Extensions

To this account shall be credited contributions in money or property made to the accounting company for the purpose of assuming the burden of any part of the burden represented by the investment necessary for the establishment or extension of services rendered by the company. This covers such items as contributions toward the cost of line extensions in sparsely settled territory made by consumers, either voluntarily or when reasonably required by the company as a condition of giving the desired service, and the cost of services to which the company has title, in so far as such cost is borne by the consumer; it also covers grants from municipal or other governmental bodies or contribu-

tions from chambers of commerce and similar organizations made with the object of establishing a new service in the community by assuming part of the investment cost of the enterprise.

Note.—This does not include advances for the construction of extensions which are ultimately to be repaid wholly or in part to the consumer; such advances should be credited to account No. 261, "Miscellaneous Unadjusted Credits". When final determination has been made as to the amount of the advances to be returned to the consumer, the balance, if any, shall be credited to this account."

Account No. 261 provides as follows:

"261. Miscellaneous Unadjusted Credits

This account shall include the amount of credit balances in suspense accounts that can not be entirely cleared and disposed of until additional information is received."

[fol. 23] With respect to those contracts which do not provide for refunds, the cash payments are debited to cash and credited to an account designated "255—Contributions for Extensions" as required by the Uniform Classification of Accounts for Electric Utilities prescribed by Michigan Public Utilities Commission.

(11) The Petitioner under the terms of certain of the Agreements (Exhibits 1-4 inclusive), relating to the construction of a line extension is under a legal liability upon the happening of certain conditions during the first five calendar years following the construction of the requested extension to refund to the applicant for service the full amount of the applicant's payment. The amount of the refund and the time for the making thereof is in some cases determined by the number of additional customers who subscribed to the service subsequent to the building of the extension, while in others, the revenue derived by the Petitioner from the line extension is the measure of the customer's refund. After the expiration of five calendar years following the building of the line extension, the liability of the Petitioner to refund any part of the payment ceases.

Under some of the contracts, (Ex. 5) the applicant is not entitled to receive refunds.

The following tabulation represents unrefunded balances of payments made by applicants for line extension under

the provisions of Exhibits 1-5 inclusive at the date given, and which were then not subject to further refunds.

	12-31-35	12-31-36	12-31-37
Unrefunded balance of payments made under line extension agreements providing for refunds to customers:			
Regular O. H. Line (See Exhibits I & II)	$452,020.56	$461,447.54	$465,363.42
Farm O. H. Line (See Exhibits III & IV)	441,791.91	464,571.68	486,084.66
Gas Extension (No Standard form)	834.27	834.27	834.27
Total	$894,646.74	926,853.49	952,282.35
[fol. 24]			
Payments made by applicants for line extensions under the terms of a contract and under which the applicant is not entitled to receive any refund (See Exhibit V)	2,005.00	2,005.00	10,225.44
Miscellaneous line extension agreements covered by various types of contract but with respect to which the applicant is not entitled to receive any refund (no agreement forms)	$252,028.12	255,887.18	269,738.55
Totals	$254,033.12	257,892.18	279,963.99
Grand Totals	$1,148,679.86	$1,184,746.67	$1,232,246.34

(12) Unrefunded balances not subject to further refunds (under the provisions of Exhibits 1-4 inclusive), and the balance of payments made and not refundable (under the Provisions of Exhibits 5) were transferred to surplus by the Petitioner in the years and amounts set opposite thereto as follows:

November 30, 1932	$992,802.07
December 31, 1933	54,396.53
December 31, 1934	45,963.87

The foregoing sums represent the total balances of Account 255—"Contributions for Extensions" as of the date the respective transfers were made.

(13) As of December 31, 1935, the total amount paid by such applicants, less any refunds made in accordance with any of the five types of agreements, (Exhibits 1-5), was $1,148,679.86. Said amount representing unrefunded deposit balances with respect to which the five year period

within which refunds might have been made under the terms of the contract, had expired, and amounts paid under contracts which do not provide for a refund.

As of December 31, 1936, the total amount paid by such applicants, less any refunds made in accordance with any of the five types of agreements, (Exhibits 1-5), was $1,184,745.67. Said amount representing unrefunded deposit [fol. 25] balances with respect to which the five year period within which refunds might have been made under the terms of the contract had expired, and amounts paid under contracts which do not provide for a refund.

As of December 31, 1937, the total amount paid by such applicants, less any refunds, made in accordance with any of the five types of agreements, (Exhibits 1-5), was $1,232,246.34. Said amount representing unrefunded deposit balances with respect to which the five year period within which refunds might have been made under the terms of the contract, had expired, and amounts paid under contracts which do not provide for a refund.

(14) The Petitioner following the building of the line extension is obligated to thereafter keep and maintain the line thus constructed, including replacement in whole or in part as and when necessary, so that service will thereafter be available to the customer or customers.

(15) During the years 1936 and 1937, the Petitioner did not report as taxable income the sums of $36,065.81 and $47,500.67. These sums represent the balance of unrefunded payments made by applicants for line extensions, and with respect to which the five year period during which refunds might have become due to such applicants, expired during each of said years. The applicants were thereafter no longer entitled to receive refunds with respect to such unrefunded balances. The Respondent did not subject said sums to Federal Income Tax.

(16) The Commissioner claims that the amount recoverable through depreciation is the original cost of construction of the line extension as shown by the Petitioner's books, diminished by the total amount paid by customers under certain agreements providing for no refund to customers, and also diminished by the unrefunded balances of amounts paid by customers under other agreements providing for refunds to such customers, and with respect to which the

five year period within which refunds might have been [fol. 26] made, had expired. The Petitioner claims that the amount recoverable through depreciation is the original cost of construction of line extensions as shown by the Petitioner's books, without any deduction for the amounts paid by the customers.

The following tabulation represents the unrefunded balances of amounts paid by applicants for line extensions in prior years, and which the Petitioner claims should be included in the depreciable base. It also represents the rate of depreciation and the amount of depreciation for the calendar years 1936 and 1937.

Year	Average Depreciable Base Disallowed	Rate	Amount of Depreciation Disallowed
1936	$1,146,010.89	3.4604	$39,656.56
	19,409.84	3.0104	584.31
	1,292.04	2.4951	32.24
	$1,166,712.77		$40,273.11
1937	$1,187,562.04	3.4661	$41,162.09
	19,641.93	3.0137	591.95
	1,292.04	2.4940	32.22
	$1,208,496.01	—	$41,786.26

(Signed) J. P. Wenchel, P.M.C., Attorney for Commissioner. The Detroit Edison Company, by A. C. Marshall, President.

(Signed) Edward H. Green, Oscar C. Hull, Harvey A. Fischer, Attorneys for Petitioner.

[fol. 27] EXHIBIT I TO STIPULATION OF FACTS

Agreement for Line Extensions

Memorandum of Agreement, Made this — day of —— Nineteen Hundred ——, by and between The Detroit Edison Company, a corporation operating under the laws of the State of Michigan, hereinafter called the Company, and —— —— of ——, —— County, Michigan, hereinafter called the Customer.

Whereas, the said Customer has applied to the said Company for its electrical service at ——, —— County, Michigan; and, Whereas, the Company does not consider war-

ranted at the present time the investment in poles, wires, etc., necessary to extend its lines to the places where the said service is desired;

Therefore it is Agreed between the parties hereto, as follows:

First: The Company shall build the necessary line extension from —— —— to —— —— in accordance with its standard construction, said line to be and remain the property of the Company and become part of its system.

Second: The Customer shall pay to the Company the sum of (1) —— dollars for the building of the said line, said amount to be paid at the time of signing of this agreement.

Third: At the end of the calendar year during which the said line shall have been built the Company shall refund to the Customer, or his assignee, an amount equal to one-half of the Company's revenues from the said line from the time the line was built to the end of the calendar year. At the end of each of the succeeding five calendar years the Company shall similarly refund to the Customer, or his [fol. 28] assignee, one-half of the revenues from the said line for that year; provided that the aggregate amount of the said refunds shall not exceed (1) —— dollars, and that no refund shall be made on the basis of revenues derived from the said line after the expiration of the fifth calendar year following the calendar year in which the said line is completed.

In execution whereof the parties hereto have set their hands the day and year first above written.

The Detroit Edison Company by —— ——, Special Agent. —— ——, (Customer).

Instructions

1. The amount to be written into the spaces in the Second clause and the Third clause of this agreement is the estimated cost of the building of the line extension, at the prices for material and labor prevailing at the time of the construction, plus 10% additional to cover all overhead costs.

2. For definition of *Line Extensions*, as distinguished from *Service Connections*, see extracts from the Company's

rule concerning *Line Extensions and Service Connections*, as filed with the Michigan Public Utilities Commission, reprinted on the back hereof.

3. In case the Customer elects to build the Line Extension (See Section 5 of the Company's rule concerning Line Extensions and Service Connections, reprinted on the back hereof), proper rider is to be attached to this agreement, amending the First and Second clauses thereof to this effect, and specifying the amount to be written into the space in the Third clause of the agreement.

4. Copy of this agreement is to be given to the Customer.

[fol. 29] EXHIBIT I (Reverse)

Extracts from the Company's Rule Concerning Line Extensions and Service Connections

(Reprinted from rule 5 filed with Michigan Public Utilities Commission.)

2. The Company reserves to itself the right to decide (subject to appeal to the Michigan Public Utilities Commission) whether or not any proposed or requested extension of lines shall or shall not be made.

4. *A Line Extension* (for the purposes of this Rule) is defined as the wires, insulators, insulator supports, cross arms, poles, braces, guys and guy stubs, set up or to be set up on a public highway ready for the delivery of electric supply to the applicant in question; and is measured from the point of connection to a previously existing low tension line of the Company, to the point where the Service Connection (See Section 6) is made or to be made to serve the applicant, or the furthest such Service Connection, if there be more than one applicant; including an overhead ground wire, if any be used, and special construction required for a railroad crossing or crossings or on account of unusual physical obstacles; but not including line switches, fuses, lightning arresters and transformers, notwithstanding that they may be necessary.

5. Where a proposed line extension will require an expenditure out of proportion to the revenue obtainable therefrom, the proposed extension may be made (subject to the

reservation of Section 2 hereof) under the terms of the Agreement for Line Extensions, as hereinafter specified. This applies particularly to extensions in subdivisions platted but not adequately built up (or building up) with permanent residences, and to rural extensions.

In such cases the applicant for service may build the line extension for the same at his cost, according to the Company's specifications; or may employ the Company to build the same at his cost, payable in advance; and in either such case the Company will refund to the applicant, or his assignee, one-half of the revenues from the said line extension from the time it was built to the end of the fifth succeeding calendar year; provided that the amount refunded shall not exceed the cost of the said line extension; all as set forth in the Agreement for Line Extension filed herewith and made part of this Rule, • • • • •

Service Connections

6. The Company will make, at its own expense, overhead service connections for low tension service requiring only a single span swung from the premises to a pole line on the abutting highway; or, alternatively, low tension underground service connections not greater in length than the width of the highway plus the necessary length within the customer's premises to pass through his basement wall to the service switch at the entrance point. The provisions of this section do not apply to service connections for primary (high tension) current for which see Section 8.

7. The Company will, as heretofore, furnish line wire and insulators for overhead service connections greater than [fol. 30] one span in length, and being, except the entering span, entirely on the premises of the customer, or upon a private right of way provided by him, in accordance with, and upon signature of, the *Agreement for Service Extension on Private Property*, filed herewith and made part of this Rule, • • • • •

The provisions of this Section do not apply to service connections for primary (high tension) current, for which see Section 8.

8. Service Connections for the delivery of primary (high tension) current, nominal 4400 volts, will, as heretofore, be

made entirely at the expense of the customer. Within the corporate limits of any city or village such service connections will be made underground, this construction being usually required for public safety.

EXHIBIT II TO STIPULATION OF FACTS

Agreement for Line Extension - Regular D E Co Form SA 145

Memorandum of Agreement, Made this ..... day of ..... Nineteen Hundred ..... by and between The Detroit Edison Company, a corporation operating under the laws of the State of Michigan, hereinafter called the Company, and ..... of ..... County, Michigan, hereinafter called the Customer.

Whereas, the said Customer has applied to the said Company for its electrical service at ..... County, Michigan; and,

Whereas, the Company does not consider warranted at the present time the investment in poles, wires, etc., necessary to extend its lines to the place where the said service is desired;

Therefore it is Agreed between the parties hereto, as follows:

First: The Company shall build the necessary line extension from ..... to ..... in accordance with its standard construction, said line to be [fol. 31] and remain the property of the Company and become part of its system.

Second: The Customer shall pay to the Company the sum of (1) ..... dollars for the building of the said line, said amount to be paid at the time of signing of this agreement.

Third: At the end of the calendar year during which the said line shall have been built the Company shall refund to the Customer, or his assignee, an amount equal to one-half of the Company's revenues from the said line from the time the line was built to the end of the calendar year. At the end of each of the succeeding five calendar years the Com-

pany shall similarly refund to the Customer, or his assignee, one-half of the revenues from the said line for that year; provided that the aggregate amount of the said refunds shall not exceed (1) dollars, and that no refund shall be made on the basis of revenues derived from the said line after the expiration of the fifth calendar year following the calendar year in which the said line is completed.

In execution whereof the parties hereto have set their hands the day and year first above written.

The Detroit Edison Company. By —— ——, Special Agent; —— ——, (Customer).

Instructions

1. The amount to be written into the spaces in the Second clause and the Third clause of this agreement is the estimated cost of the building of the line extension, at the prices for material and labor prevailing at the time of the construction, plus 10% additional to cover all overhead costs.

[fol. 32] 2. For definition of *Line Extensions*, as distinguished from *Service Connections*, see extracts from the Company's rule concerning *Line Extensions and Service Connections*, as filed with the Michigan Public Utilities Commission, reprinted on the back hereof.

3. In case the Customer elects to build the Line Extension (See Section 5 of the Company's rule concerning Line Extensions and Service Connections, reprinted on the back hereof), proper rider is to be attached to this agreement, amending the First and Second clauses thereof to this effect, and specifying the amount to be written into the space in the Third clause of the agreement.

4. Copy of this agreement is to be given to the Customer.

Exhibit II (Reverse)

Extracts from the Company's Rule Concerning Line Extensions and Service Connections

(Reprinted from rule 5 filed with Michigan Public Utilities Commission)

2. The Company reserves to itself the right to decide (subject to appeal to the Michigan Public Utilities Com-

mission) whether or not any proposed or requested extension of lines shall or shall not be made.

4. *A Line Extension* (for the purposes of this Rule) is defined as the wires, insulators, insulator supports, cross arms, poles, braces, guys and guy stubs, set up or to be set up on a public highway ready for the delivery of electric supply to the applicant in question; and is measured from the point of connection to a previously existing low tension line of the Company, to the point where the Service Connection (See Section 7) is made or to be made to serve the applicant, or the furthest such Service Connection, if there be more than one applicant; including an overhead ground wire, if any be used, and special construction required for a railroad crossing or crossings or on account of unusual physical obstacles; but not including line switches, fuses, lightning arresters and transformers, notwithstanding that they may be necessary.

5. Where a proposed line extension will require an expenditure out of proportion to the revenue obtainable therefrom, the proposed extension may be made (subject to the reservation of Section 2 hereof) under the terms of the Agreements for Line Extensions, as hereinafter specified. The regular form of agreement applies particularly to extensions in subdivisions platted but not adequately built up (or building up) with permanent residences, and to rural extensions. The optional form of agreement applies only to farm extensions.

Under the Regular Agreement the applicant for service may build the line extension for the same at his cost, according to the Company's specifications; or may employ the Company to build the same at his cost, payable in advance; and in either such case the Company will refund to the applicant, or his assignee, one-half of the revenues from the said line extension from the time it was built to the end of [fol. 33] the fifth succeeding calendar year; provided that the amount refunded shall not exceed the cost of the said line extensions; all as set forth in the Regular Agreement for Line Extension filed herewith and made part of this Rule.

Service Connections

7. The Company will make, at its own expense, overhead service connections for low tension service requiring only a

single span swung from the premises to a pole line on the abutting highway; or, alternatively, low tension underground service connections not greater in length than the width of the highway plus the necessary length within the customer's premises to pass through his basement wall to the service switch at the entrance point. The provisions of this section do not apply to service connections for primary (high tension) current, for which see Section 10.

8. The Company will, as heretofore, furnish line wire and insulators for overhead service connections greater than one span in length, and being, except the entering span, entirely on the premises of the customer, or upon a private right of way provided by him, in accordance with, and upon the signature of, the *Agreement for Service Connection on Private Property*, filed herewith and made part of this Rule.

* * * * * * *

10. Service Connections for the delivery of primary (high tension) current, nominal 4400 volts, will as heretofore, be made entirely at the expense of the customer. Within the corporate limits of any city or village such service connections will be made underground, this construction being usually required for public safety.

EXHIBIT III TO STIPULATION OF FACTS

Agreement For Line Extensions (Optional for Farm Lines)

Memorandum of Agreement, Made this day of Nineteen Hundred by and between The Detroit Edison Company, a corporation operating under the laws of the State of Michigan, hereinafter called the Company, and of County, Michigan, hereinafter called the Customer.

Whereas, the said Customer, for himself and associates, has applied to the said Company for its electric service at

[fol. 34] County, Michigan; and, Whereas, the Company does not consider warranted at the present time the investment in poles, wires, etc., necessary to extend its lines to the place where the said service is desired;

Therefore it is Agreed between the parties hereto, as follows:

First: The Company shall build the necessary line extension from .....

to .....
in accordance with its standard construction, said line to be and remain the property of the Company and become part of its system.

Second: The Customer shall pay to the Company the sum of (1) ..... dollars as a contribution toward the building of the said line, said amount to be paid at the time of signing of this agreement.

In execution whereof the parties hereto have set their hands the day and year first above written.

The Detroit Edison Company. By —— ——, Special A nt. —— ——, (Customer).

Instructions

1. The amount to be written into the space in the Second clause of this agreement is the estimated cost of the building of the line extension, at the rate of $1,500.00 per mile of extension (fractions of miles at proportionate rate) less allowance of $100.00 per customer agreeing to take the service at the time of building the line.

2. For definition of *Line Extensions*, as distinguished from *Service Connections*, see extracts from the Company's rule concerning *Line Extensions and Service Connections*, as filed with the Michigan Public Utilities Commission, reprinted on the back hereof.

3. Copy of this agreement is to be given to the Customer.

[fol. 35] Exhibit III (Reverse)

Extracts from the Company's Rule Concerning Line Extensions and Service Connections

(Reprinted from rule 5 filed with Michigan Public Utilities Commission)

2. The Company reserves to itself the right to decide (subject to appeal to the Michigan Public Utilities Com-

mission) whether or not any proposed or requested extension of lines shall or shall not be made.

4. *A Line Extension* (for the purposes of this Rule) is defined as the wires, insulators, insulator supports, cross arms, poles, braces, guys and guy stubs, set up or to be set up on a public highway ready for the delivery of electric supply to the applicant in question; and is measured from the point of connection to a previously existing low tension line of the Company, to the point where the Service Connection (See Section 7) is made or to be made to serve the applicant, or the furthest such Service Connection, if there be more than one applicant; including an overhead ground wire, if any be used, and special construction required for a railroad crossing or crossings or on account of unusual physical obstacles; but not including line switches, fuses, lightning arresters and transformers, nothwithstanding that they may be necessary.

5. Where a proposed line extension will require an expenditure out of proportion to the revenue obtainable therefrom, the proposed extension may be made (subject to the reservation of Section 2 hereof) under the terms of the Agreements for Line Extensions, as hereinafter specified. The regular form of agreement applies particularly to extensions in subdivisions platted but not adequately built up (or building up) with permanent residences, and to rural extensions. The optional form of agreement applies only to farm extensions.

* * * * * * *

6. Farm Line Extensions may, at the option of the proposed customers, be built under the following optional form of agreement, which provides that the customers shall contribute $1,500.00 per mile of line, less $100.00 per customer connected at the time the line is built.

Service Connections

7. The Company will make, at its own expense, overhead service connections for low tension service requiring only a single span swung from the premises to a pole line on the abutting highway; or, alternatively, low tension underground service connections not greater in length than the width of the highway plus the necessary length within the customer's premises to pass through his basement wall to

the service switch at the entrance point. The provisions of this section do not apply to service connections for primary (high tension) current for which see Section 9.

8. The Company will, as heretofore, furnish line wire and insulators for overhead service connections greater than one span in length and being, except the entering span, [fol. 36] entirely on the premises of the customer, or upon a private right of way provided by him, in accordance with, and upon signature of, the *Agreement for Service Extension on Private Property*, filed herewith and made part of this Rule, * * *

The provisions of this Section do not apply to service connections for primary (high tension) current, for which see Section 9.

9. Service Connections for the delivery of primary (high tension) current, nominal 4400 volts, will, as heretofore, be made entirely at the expense of the customer. Within the corporate limits of any city or village such service connections will be made underground, this construction being usually required for public safety.

EXHIBIT IV TO STIPULATION OF FACTS

Agreement For Line Extensions

(Optional for farm lines)

D. E. Co. Form S.A. 131

Memorandum of Agreement, Made this — day of — Nineteen Hundred — by and between The Detroit Edison Company, a corporation operating under the laws of the State of Michigan, hereinafter called the Company, and — of —, — County, Michigan, hereinafter called the Customer.

Whereas, the said Customer, for himself and — associates, has applied to the said Company for its electric service at —, — County, Michigan; and, Whereas, the Company does not consider warranted at the present time the investment in poles, wires, etc., necessary to extend its lines to the place where the said service is desired;

Therefore it is Agreed between the parties hereto, as follows:

First: The Company shall build the necessary line extension from —— to —— in accordance with its standard [fol. 37] construction, said line to be and remain the property of the Company and become part of its system. The Customer shall secure the necessary right of way for poles and lines to be set off the highway on private property, and where necessary, back of trees.

Second: The Customer shall pay to the Company the sum of (1) — dollars as a contribution toward the building of the said line, said amount to be paid at the time of signing of this agreement.

Third: The Company further agrees that a refund of $60.00 shall be given the Customer for each additional customer connected to the original extension after it has been completed; provided, however, that no refund shall be made made after the close of the fifth calendar year following that year during which the extension was built, nor shall the total refunds exceed (1) — dollars.

In execution whereof the parties hereto have set their hands the day and year first above written.

The Detroit Edison Company, By —— ——, Special Agent. —— ——(customer).

Instructions

1. The amount to be written into the space in the Second and Third clauses of this agreement is the estimated cost of the building of the line extension, at the rate of $1,000.00 per mile of extension (Fractions of miles at proportionate rate) less allowance of $100.00 per Farm Customer agreeing to take the service at the time of building the line.

2. For definition of Line Extensions, as distinguished from Service Connections, and for definition of Additional Customer see extracts from the Company's rule concerning Line Extensions and Service Connections, as filed with the Michigan Public Utilities Commission, reprinted on the back hereof.

3. Copy of this agreement is to be given to the Customer.

[fol. 38] EXHIBIT IV (Reverse)

Extracts From the Company's Rule Concerning Line Extensions and Service Connections

(Reprinted from Rule 5 Filed With Michigan Public Utilities Commission.)

2. The Company reserves to itself the right to decide (subject to appeal to the Michigan Public Utilities Commission) whether or not any proposed or requested extension of lines shall or shall not be made.

4. *A Line Extension* (for the purposes of this Rule) is defined as the wires, insulators, insulator supports, cross arms, poles, braces, guys and guy stubs, set up or to be set up on a public highway ready for the delivery of electric supply to the applicant in question; and is measured from the point of connection to a previously existing low tension line of the Company, to the point where the Service Connection (See Section 7) is made or to be made to serve the applicant, or the furthest such Service Connection, if there be more than one applicant; including an overhead ground wire, if any be used, and special construction required for a railroad crossing or crossings or on account of unusual physical obstacles; but not including line switches, fuses, lightning arresters and transformers, notwithstanding that they may be necessary.

5. Where a proposed line extension will require an expenditure out of proportion to the revenue obtainable therefrom, the proposed extension may be made (subject to the reservation of Section 2 hereof) under the terms of the Agreements for Line Extensions, as hereinafter specified. The regular form of agreement applies particularly to extensions in subdivisions platted but not adequately built up (or building up) with permanent residences, and to rural extensions. The optional form of agreement applies only to farm extensions.

. . . . . .

6. Form Line Extensions may, at the option of the proposed customers, be built under the following optional form of agreement, which provides that the customers shall contribute $1,000.00 per mile of line, less $100.00 per farm customer connected at the time the line is built, and that the

Customer shall secure right of way for poles and lines to be set off the highway on private property, and where necessary, back of trees.

Additional Customers are defined as customers not in the group originally dealt with and who are connected to the original extension after it has been completed. When an additional customer has been connected to the extension and when he begins to take service therefrom, there will be refunded to the signer of the agreement for the original extension the sum of $60.00 for each such additional customer. No refunds for additional customers will be made after the close of the fifth calendar year following that year during which the extension was built, and when refunds reach a sum equal to the amount actually paid by the original signer, all refunding shall cease.

[fol. 39] Service Connections

7. The Company will make at its own expense, overhead service connections for low tension service requiring only a single span swung from the premises to a pole line on the abutting highway; or, alternatively, low tension underground service connections not greater in length than the width of the highway plus the necessary length within the customer's premises to pass through his basement wall to the service switch at the entrance point. The provisions of this section do not apply to service connections for primary (high tension) current, for which see Section 10.

8. The Company will, as heretofore, furnish line wire and insulators for overhead service connections greater than one span in length, and being, except the entering span, entirely on the premises of the customer, or upon a private right of way provided by him, in accordance with, and upon the signature of, the *Agreement for Service Connection on Private Property*, filed herewith and made part of this Rule. * * *

10. Service Connections for the delivery of primary (high tension) current, nominal 4400 volts, will as heretofore, be made entirely at the expense of the customer. Within the corporate limits of any city or village such service connections will be made underground, this construction being usually required for public safety.

Exhibit V to Stipulation of Facts

Private Property Service Connection Agreement

D E CO FORM SA 23

Memorandum of Agreement Made and entered into this — day of ——, 19—, by and between The Detroit Edison Company, a corporation operating under laws of the State of Michigan, hereinafter called the Company, and ——— ——— of ——— —— County, Michigan, hereinafter called the Customer.

Whereas, the said Customer has applied to the said Company for its electric service at ——— ——— County, Michigan, and Whereas, there is no highway or public place by which the Company can extend its lines to the location where said service is desired.

[fol. 40] Therefore it is Agreed between the parties hereto, as follows:

(1) The Customer shall provide a feasible and reasonable route for extending the service connection from the Company's nearest pole in the highway to the location where said service is desired, and shall furnish and own a pole line conforming to the Company's specifications on the said route, including pole or poles, suitable for the support of a transformer and its appurtenances and for the attachment of the wires and insulators and shall deliver to the Company a written permit from all interested parties, granting to the Company the right and privilege of erecting and maintaining on said pole line the necessary wires and insulators to properly furnish said service.

(2) The Company shall furnish at its expense all the wire and insulators necessary to run the said service connection, and these shall be and remain the property of the Company, and when the service over said line shall cease, the Company shall be permitted to enter and repossess itself of the materials so furnished.

(3) The Company will maintain and replace when necessary the entire extension, including the poles.

(4) The Customer further requests the Company to furnish and erect the pole or poles as set forth in paragraph (1) above and it is agreed between the parties hereto that

the Company shall furnish and construct said pole line which will require the setting of ———— poles in consideration for which the Customer agrees to pay to the Company $———.

In witness whereof the parties hereto have set their hands the day and year first above written.

The Detroit Edison Company, by —— ——, Special Agent. —— ——, (Customer.)

———

[fol. 41] Instructions

1. For definition of *Service Connections* and rules concerning same see extracts from the Company's rule concerning *Line Extensions* and *Service Connections*, as filed with the Michigan Public Utilities Commission reprinted on the back hereof.

2. This agreement for Private Property Service Connection is applicable to any overhead line construction on the premises of a Customer or on his private right of way whether the same be entirely an extension of a low tension (or secondary) service connection or whether it be an extension of a high tension primary circuit to a transformer suitably located on the Customer's premises with secondary service connections beyond the transformer to the entrance switch. The agreement is not applicable to service connections which carry high tension or primary current for delivery to the customer in that form.

3. Copy of this agreement is to be given to the Customer.

— Exhibit V (Reverse)

Extracts from the Company's Rule Concerning Line Extensions and Service Connections

(Reprinted from Rule 5 Fourth Revised Sheet 8 and 8A Filed with Michigan Public Utilities Commission)

Service Connections

Overhead Low Tension Service Connections: The Company will make at its own expense from its overhead lines, low tension overhead service connections requiring only a single span swung from the pole line on the abutting high-

way to the premises. When a service connection cannot be swung by a single span the Company will furnish the wire and insulators for the extension but the customer shall *pay for and own such pole or poles as may be necessary to erect on his property.* The Company will, however, maintain and replace when necessary the entire extension, *including the poles.*

Line Extensions and Service Connections: Where a farm line has been erected on private property separated by the highway from the premises to be served and at a distance too great for a single span service connection, the Company will provide at its own cost the poles needed to bring the service connection to the property line, including the first pole needed to be set on the premises. Poles on the premises other than the first pole must be paid for by the customer.

Underground Low Tension Service Connections: The Company will make at its own expense from its underground lines low tension underground service connections from its conduit to the property line. That part of an unde-ground service connection which may extend on the Customer's property beyond the property line is at the customer's expense.

In lieu of the standard overhead connection the customer may elect to provide an underground service connection to [fol. 42] the Company's overhead pole line entirely at his expense and the Company will connect the extension to its line through a suitable pothead, the cost of the pothead and its connection to the underground service being paid by the customer and the cost of connection of the pothead to the overhead line being borne by the Company.

High Tension Service Connections: Overhead Service Connections for the delivery of primary (high tension) current will be made entirely at the expense of the customer.

Within the corporate limits of any city or village such service connections may be made underground, at the option of the Company, if it shall appear that an overhead service connection would be or become unsafe to the public. In such case, the Company will bring its conduit up to the property line at its expense and the customer shall pay for that part of the conduit within his premises and for all of the service cable.

BEFORE UNITED STATES BOARD OF TAX APPEALS

THE DETROIT EDISON COMPANY, Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 103379. Promulgated October 14, 1941

In some instances the petitioner extends its lines to outlying districts, receiving from the parties desiring the extensions deposits to cover the estimated costs thereof. The petitioner claims the deduction from gross income of the years 1936 and 1937 of depreciation upon the cost of the extensions paid for by its customers. Held, that the petitioner is not entitled to any depreciation allowance in respect of extensions paid for by its customers.

Edward H. Green, Esq., and Harvey A. Fischer, Esq., for the petitioner.

Paul A. Sebastian, Esq., for the respondent.

OPINION

SMITH:

This proceeding is for the redetermination of deficiencies in income tax for the years 1936 and 1937 in the amounts [fol. 43] of $4,031.04 and $6,267.94, respectively. The single issue raised is whether the respondent erred in disallowing deductions for depreciation in the respective amounts of $40,273.11 and $41,786.26 for the taxable years.

All of the facts material to the issue are covered in a signed stipulation of facts which we adopt as our findings of fact.

The petitioner is a corporation, organized and existing under and by virtue of the laws of the State of New York, but duly admitted and licensed to do business in the State of Michigan. It filed its income tax return for 1936 and 1937 with the collector at Detroit, Michigan.

The petitioner is a public utility corporation engaged, among other things, in the generation and sale of electric energy in the city of Detroit, Michigan, and surrounding territory, and operates under the jurisdiction of the Michigan Public Service Commission.

Petitioner, in connection with the distribution and sale of electric energy, from time to time receives applications for the extension of its transmission or distribution lines

to places which in the opinion of the petitioner are situated too far from existing transmission or distribution lines to warrant the expenditure of amounts necessary to make such extensions.

Upon payment by the applicant of a sum fixed by the petitioner, the lafter agrees in writing to make the necessary expenditures for the construction of the desired line extension. The agreement between the petitioner and each applicant is evidenced by one of five types of agreements, copies of which are made a part of the stipulated facts.

The petitioner has from time to time required the applicant to pay varying sums ranging from $500 per mile to $1,500 per mile of line extension. These amounts as fixed by the contracts represent the estimated cost per mile of line construction.

The amount of the payment made by the applicant is the estimated cost, and not the actual cost, but it never [fol. 44] exceeds the actual cost of constructing the requested line extension, and no increase or decrease is made in the amount fixed in the contract upon the completion of the line extension by reason of the actual cost thereof. The amount paid by the applicant is in all cases final as to such applicant. The applicant may, however, in accordance with the agreement in writing providing for refunds, become entitled to receive all or part of such payment upon the happening of the events provided for therein.

The material and property used in the construction of the line extension and the cost of labor is in all cases paid from the general working funds of the petitioner. The records of the petitioner set forth and identify all work performed and to be performed under the provisions of any given contract.

Upon the completion of the line extension, the petitioner, in accordance with standard practice, enters upon its books as a "property item" (such as poles, lines, etc.) the cost of the line extension, including labor and material, and does not subtract from that sum the amount of the payment made by the applicant.

Depreciation is claimed by the petitioner for income tax purposes for the years 1936 and 1937 upon the cost to the petitioner thus arrived at, at rates approved by the Commissioner.

The cash payment made by the applicant in those contracts providing for refunds is not earmarked for the build-

ing of any given line extension, but upon its receipt becomes a part of the free working capital of the petitioner. The cash account is debited with the full amount of the payment and a like amount is credited to a liability account entitled "Customers' Deposits for Line Extension", classified under account No. 261, "Miscellaneous Unadjusted Credits", as required by the Uniform Classification of Accounts for Electric Utilities prescribed by the Michigan Public Service Commission. After the expiration of the period during which refunds may be made to the customers under the [fol. 45] terms of the written contract pursuant to which line extensions have been constructed, petitioner is then required by account No. 255 to transfer the unrefunded balance, if any, from account No. 261, "Miscellaneous Unadjusted Credits", to account No. 255, "Contributions for Extensions." With respect to those contracts which do not provide for refunds, the cash payments are debited to cash and credited to account No. "255—Contributions for Extensions."

At the expiration of the five-year period during which refunds may be made to depositors, the petitioner credits to surplus the amount of the unrefunded balance with respect to each agreement expiring during the taxable year. During the years 1936 and 1937 the petition thus credited to surplus $36,065.81 and $47,500.67. In its income tax returns for 1936 and 1937 petitioner did not report in taxable income the above amounts credited to surplus. The respondent did not in the determination of the deficiencies subject such sums to Federal income tax.

In lieu thereof the respondent held that the petitioner was not entitled to deduct depreciation upon such part of the cost of line extensions covered by the agreements as was presented by the unrefunded balances of deposits. The unrefunded balances of the deposits at the close of each of the years 1935, 1936, and 1937 were as follows:

1935	$1,148,679.86
1936	1,184,745.67
1937	1,232,246.34

In the determination of the deficiencies the respondent has disallowed a depreciation deduction upon the mean of those balances between the beginning and close of each of the years 1936 and 1937. These media were for $1,166,-

712.77 for 1936 and $1,208,496.01 for 1937. The depreciation disallowed for 1936 and 1937 was $40,273.11 and $41,786.26, respectively.

In its income tax returns for 1936 and 1937 the petitioner claimed a depreciation allowance upon the total cost of its depreciable properties, including the full amount [fol. 46] of the cost of line extensions, a part of which was paid for by its customers. In the determination of the deficiencies the respondent has disallowed depreciation upon such portion of the cost of its depreciable properties as was represented by the unrefunded balances of deposits referred to above.

The respondent's argument is that the petitioner is not entitled to a depreciation allowance except upon the cost of depreciable properties borne by it. He admits that under the principle of Edwards v. Cuba Railroad Co., 268 U. S. 628; Liberty Light & Power Co., 4 B. T. A. 155; Great Northern Railway Co., 8 B. T. A. 225; Frank Holton & Co., 10 B. T. A. 1317; and Baltimore & Ohio Railroad Co., 30 B. T. A. 194, the petitioner is not taxable upon the gain realized by it from the unrefunded deposits credited to surplus in 1936 and 1937 of $36,065.81 and $47,500.67, respectively. He contends, however, that if the petitioner is entitled to deduct depreciation upon the cost of extensions borne by its customers it obtains a double benefit, which is not warranted by the statute.

We think that the contention of the respondent upon this point must be sustained. In United States v. Ludey, 274 U. S. 295, the Supreme Court said:

> • • • The amount of the allowance for depreciation is the sum which should be set aside for the taxable year, in order that, at the end of the useful life of the plant in the business, the aggregate of the sums set aside will (with the salvage value) suffice to provide an amount equal to the **original cost.** The theory underlying this allowance for depreciation is that by using up the plant a gradual sale is made of it. The depreciation charged is the measure of the **cost** of the part which has been sold. • • • (Emphasis supplied.)

It is fundamental that the depreciation deduction is allowed upon a capital investment. Where a taxpayer has no capital investment in property it is not entitled to a

depreciation allowance in respect of the capital asset. The essential requirements of a capital investment are the laying [fol. 47] out of money or money's worth and the acquisition of something of permanent use or value in the business. La Belle Iron Works v. United States, 256 U. S. 377. The mere ownership of property which cost the owner nothing does not give rise to the right of a depreciation allowance.

Petitioner, in effect, claims that we must treat the deposits as mere contributions to its capital, and that the building and ownership of the lines must be treated as a separate transaction. The petitioner's argument is that the statute does not permit us to "trace the funds" with which the power lines were built and that the mere facts that the lines are owned by the company, are used in its business, and have a limited useful life require us to sustain its position. The difficulty with this argument is that it overlooks the very substance of the transactions involved. The contracts can not be broken down as suggested, for they are in essence contract the very purpose of which is to permit the company to avoid the cost of constructing new lines. If we were to sustain the petitioner's argument it would be to permit the petitioner to recover through depreciation allowances the cost of line extensions which was not borne by itself. The respondent's determination of deficiencies is approved.

Decision will be entered for the respondent.

45 B.T.A.

BEFORE UNITED STATES BOARD OF TAX APPEALS

DECISION—Entered October 14, 1941

Pursuant to the determination of the Board, as set forth in its opinion promulgated October 14, 1941, it is

Ordered and Decided: That there are deficiencies in income tax for the years 1936 and 1937 in the respective amounts of $4,031.04 and $6,267.94.

(Signed) R. R. Arundell, Member.

[fol. 48] BEFORE UNITED STATES BOARD OF TAX APPEALS

PETITION OF THE DETROIT EDISON COMPANY FOR REVIEW BY THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SIXTH CIRCUIT OF A DECISION BY THE UNITED STATES BOARD OF TAX APPEALS—Filed January 10, 1942

To the Honorable Judges of the United States Circuit Court of Appeals for the Sixth Circuit:

The Detroit Edison Company, the petitioner in this cause, by Edward H. Green, Harvey A. Fischer and Oscar C. Hull, counsels, hereby files its petition for a review by the United States Circuit Court of Appeals for the Sixth Circuit of the decision by the United States Board of Tax Appeals rendered October 14, 1941, 45 B. T. A., No. 64, and entered on the same day determining deficiencies in the petitioner's Federal income tax for the years 1936 and 1937, in the respective amounts of $4,031.04 and $6,267.94, and respectfully shows:

1. The party seeking this review is The Detroit Edison Company. The petitioner, The Detroit Edison Company is a corporation duly organized and existing under and by virtue of the laws of the State of New York, with its principal office for the transaction of its corporate business at 2000 Second Avenue, Detroit, Michigan.

2. The taxable periods involved are the calendar years 1936 and 1937.

3. The petitioner filed its Federal income tax return for each of the years 1936 and 1937 in the office of the Collector of Internal Revenue for the Michigan District, which office is, and was at the time said return was filed, located at Detroit, Michigan, within the Sixth Circuit.

4. The respondent herein is the Commissioner of Internal Revenue, Washington, D. C., and said respondent appeared in the United States Board of Tax Appeals by J. P. Wenchel, Chief Counsel of the Bureau of Internal Revenue, Washington, D. C.

Wherefore, the petitioner prays that the decision of the Board of Tax Appeals be reviewed by the United States Circuit Court of Appeals for the Sixth Circuit, that a transcript of the record be prepared in accordance with law

[fol. 49] and with the rules of said Court and transmitted to the Clerk of said Court for filing, and that appropriate action be taken to the end that the errors complained of may be reviewed and corrected by said Court.

Edward H. Green, Attorney for Petitioner. Business Address: No. 48 Wall Street, New York, New York.

Oscar C. Hull, Attorney for Petitioner. Business Address: 1101-14 Dime Building, Detroit, Michigan.

Harvey A. Fischer, Attorney for Petitioner. Business Address: 1101-14 Dime Building, Detroit, Michigan.

(Duly verified.)

BEFORE UNITED STATES BOARD OF TAX APPEALS

STATEMENT OF POINTS TO BE RELIED ON—Filed January 10, 1942

The Detroit Edison Company, being aggrieved by the findings of fact and conclusions of law contained in the opinion of the Board, and by its decision entered pursuant thereto, hereby states that the points on which it intends to rely in this appeal are as follows:

1. The Board of Tax Appeals erred in holding that petitioner's depreciation basis for the calendar year 1936 should be reduced in the amount of $1,166,712.77 representing payments made by customers to petitioner on applications for certain line extensions.

2. The Board of Tax Appeals erred in holding that petitioner's depreciation deduction should be reduced for the calendar year 1936 by the amount of $40,273.11, represent- [fol. 50] ing the application of the petitioner's rate of depreciation on line extensions to said sum of $1,166,712.77.

3. The Board of Tax Appeals erred in holding that petitioner's depreciation basis for the calendar year 1937 should be reduced in the amount of $1,208,496.01 representing payments by customers to petitioner on applications for certain line extensions.

4. The Board of Tax Appeals erred in holding that petitioner's depreciation deduction should be reduced for the calendar year 1937 by the amount of $41,786.26, repre-

senting the application of the petitioner's rate of depreciation on line extensions to said sum of $1,208,496.01.

5. The Board of Tax Appeals erred in failing to find that petitioner was entitled to a depreciation deduction for the calendar year 1936 in the amount of $40,273.11 greater than the amount of depreciation allowed by the Commissioner.

6. The Board of Tax Appeals erred in failing to find that petitioner was entitled to a depreciation deduction for the calendar year 1937 in the amount of $41,786.26 greater than the amount of depreciation allowed by the Commissioner.

7. The Board of Tax Appeals erred in holding that the petitioner's basis for the purpose of computing depreciation on certain line extensions should be reduced on account of certain payments made by certain customers served by such line extensions.

8. The Board of Tax Appeals erred in directing the entry of judgment for the respondent for deficiencies in income tax for the years 1936 and 1937 in the respective amounts of $4,031.04 and $6,267.94, and in not finding for petitioners that there was no deficiency in income tax for said years.

Edward H. Green, Attorney for Petitioner. Oscar C. Hull, Attorney for Petitioner. Harvey A. Fischer, Attorney for Petitioner.

[fol. 51] BEFORE UNITED STATES BOARD OF TAX APPEALS

NOTICE OF FILING PETITION FOR REVIEW AND STATEMENT OF POINTS—Filed January 13, 1942

You are hereby notified that The Detroit Edison Company did, on the 10th day of January, 1942, file with the Clerk of the United States Board of Tax Appeals, at Washington, D. C., a petition for review by the United States Circuit Court of Appeals for the Sixth Circuit, of the decision of the Board heretofore rendered in the above entitled case. Copies of the petition for review and the

statement of points as filed are hereto attached and served upon you.

Dated this 12th day of January, 1942.

(S.) B. D. Gamble, Clerk, U. S. Board of Tax Appeals.

Service of copy of Petition for Review and Statement of Points acknowledged this 12th day of January, 1942.

J. P. Wenchel, Attorney for Respondent.

BEFORE UNITED STATES BOARD OF TAX APPEALS

COUNTER-DESIGNATION OF CONTENTS OF RECORD ON APPEAL—Filed January 22, 1942

To the Clerk of the United States Board of Tax Appeals:

Please prepare, transmit and deliver to the Clerk of the United States Circuit Court of Appeals for the Sixth Circuit, copies duly certified as correct of the following documents and records in the above-entitled cause, in connection with the petition for review by the said Circuit Court of Appeals for the Sixth Circuit heretofore filed by the petitioner herein:

1. Docket entries of the proceedings before the Board.

2. Pleadings before the Board,

[fol. 52] (a) Petition, including annexed copy of deficiency letter with attached exhibits, dated the 26th day of April, 1940.

(b) Answer.

3. Stipulation of facts, including exhibits, entered into between the attorneys for the plaintiff in this action on the one side and the Chief Counsel for the Bureau of Internal Revenue on the other.

4. Opinion of the Board of Tax Appeals.

5. Decision of the Board of Tax Appeals.

6. Petition for review, together with proof of service of notice of filing petition for review and of service of one copy of petition for review.

7. This counter-designation of the contents of record on appeal.

J. P. Wenchel, Chief Counsel, Bureau of Internal Revenue.

Clerk's Certificate to foregoing transcript omitted in printing.

[fol. 53] In United States Circuit Court of Appeals for the Sixth Circuit

Cause Argued and Submitted—October 15, 1942

Before Hicks, Hamilton and Martin, JJ.

This cause is argued by Norris Darrell and Harvey A. Fischer for Petitioner and by Arthur Manella for Respondent and is submitted to the court.

In United States Circuit Court of Appeals

Judgment—Entered November 30, 1942

Appeal from the United States Board of Tax Appeals

This cause came on to be heard on the transcript of record from the United States Board of Tax Appeals, and was argued by counsel.

On consideration whereof, It is now here ordered, adjudged and decreed by this Court that the order or decree of the said Board of Tax Appeals in this cause be and the same is hereby affirmed.

[fol. 54] In United States Circuit Court of Appeals

Opinion—Filed November 30, 1942

Before Hicks, Hamilton and Martin, Circuit Judges

Hamilton, Circuit Judge:

This is a proceeding for a review of a decision of the United States Board of Tax Appeals to redetermine a deficiency in petitioner's income and excess profits taxes for

the years 1936 and 1937 in the respective amounts of $4,031.04 and $6,267.94. A single issue is presented, viz., what sum, if any, petitioner is entitled to deduct from gross income on account of depreciation of a capital asset, the cost of which was contributed by prospective users of its electric lines.

The petitioner is a public utility corporation of New York, licensed to do business in Michigan, and is engaged in generating and selling electric energy in the city of Detroit and surrounding territory and operates under the jurisdiction of the Michigan Public Service Commission.

Petitioner, in connection with the distribution and sale of electric energy, from time to time receives applications for extension of its transmission or distribution lines to places which, in petitioner's opinion, are situated too far from its existing lines to warrant the expenditure of the amounts necessary to make such extensions. In such cases petitioner, prior to the construction of the desired extension, requires the applicant to pay to it a sum representing the estimated cost per mile for construction of such extension, which is agreed to in writing.

The record shows four types of agreements: (I) The customer shall pay to the petitioner in cash the estimated cost of constructing the line and procurement of the right-of-way. At the end of each calendar year, beginning with the end of the year of construction and for four years thereafter, petitioner agrees to refund to the customer or his assignee an amount equal to one-half of petitioner's revenue from the line, the aggregate refund not to exceed the amount contributed by the customer.

[fol. 55] (II) The customer in no event is entitled to recover any part of his contribution.

(III) The customer is entitled to a refund of $60.00 for each additional customer not named in the contract connected with the original extension after its completion, provided however, that no refund shall be made after the close of the fifth calendar year following that year during which the extension was built, nor shall the total refund in any event be in excess of the sum originally contributed by the customer.

(IV) The customer is required to provide a feasible and reasonable route for the extension of the service

connection from petitioner's nearest pole in the highway to the location where said service is desired and shall furnish the necessary poles to support a transformer and its appurtenances and for the attachment of the wires and insulators and the customer shall deliver to petitioner a written permit from all interested parties granting the petitioner the right of erecting and maintaining on said pole line the wire and insulators necessary to properly furnish the service. The petitioner is to furnish at its expense all wires and insulators necessary to operate said service connection which shall be and remain its property and when service over the line ceases, petitioner shall be entitled to repossess all the materials so furnished but shall maintain and replace the entire extension including the poles so long as the service is in operation. If the petitioner furnishes and constructs the pole line, the customer shall pay the cost thereof and the customer recovers no part of his contribution.

The material and labor used in the construction of the line extensions under the foregoing contracts were paid from the general working funds of the petitioner and it made in its books of accounts entries identifying all work performed under the provisions of each respective contract.

Upon the completion of the line extensions, petitioner in accordance with its regular system of accounting entered upon its books as a property item the cost thereof. It made [fol. 56], no book reduction in the cost of construction on account of the sums it had theretofore received from prospective customers. The cash payments received from applicants under contracts providing for contingent refunds were not earmarked in petitioner's accounts for the building of line extensions, but the sums received were carried into petitioner's accounts of free working capital. Petitioner's cash account was debited for the amount of the payments and credited to a liability account entitled "Customers Deposits for Line Extensions" and further classified as "Miscellaneous Unadjusted Credits." This method of accounting was in accordance with the accounting regulations of the Michigan Public Service Commission.

At the expiration of the period of refundment to customers, the petitioner transferred the unrefunded balances from "Miscellaneous Unadjusted Credits" to an account designated "Contributions for Extensions." There was also included in this account sums received from customers

who were not entitled to refunds. On its books petitioner debited these sums to cash and credited them to "Contributions for Extensions." When the period expired for refundments to contributing customers, all remaining balances in the accounts were credited to surplus. During the years 1936 and 1937, petitioner's surplus was increased from this source $36,065.81 and $47,500.67 respectively. Neither of these items was included in petitioner's gross income. The Board found that petitioner's capital sum recoverable through depreciation allowance, with the exception of refunds, did not include the cost of construction of extensions where its prospective customers had contributed to petitioner a sum equal to the cost thereof. It accordingly reduced petitioner's capital sum for the purposes of depreciation the mean of the unrefunded balances of customers' deposits between the beginning and close of each of the years 1936 and 1937. These media for the years 1936 and 1937 were $1,166,712.27 and $1,208,496.01 respectively. The net result was the disallowance of $40,273.11 depreciation deduction for the year 1936 and $41,[fol. 57] 786.27 for the year 1937. These disallowances which petitioner seeks to have reinstated in these proceedings resulted in the deficiency in taxes.

Section 23(l) of the Revenue Act of 1936, c. 690, 48 Stat. 648 [Internal Revenue Code, 26 U. S. C. A., Sec. 23(l)] authorizes, as a deduction from gross income, a reasonable allowance for depreciation of property used in the trade or business of a taxpayer. Section 23(n) of the same Act [Internal Revenue Code, 26 U. S. C. A., Sec. 23(n)] fixes the basis for depreciation as provided in Section 114. Section 114 [Internal Revenue Code, 26 U. S. C. A., Section 114(a)] provides that the basis for depreciation shall be the adjusted basis provided in Section 113(b) for the purpose of determining the gain or loss upon the sale or other disposition of such property.

Section 113(b) of the Act [Internal Revenue Code, 26 U. S. C. A., Section 113(b)] provides the adjusted basis for determining the gain or loss from the sale or other disposition of property shall be the basis determined under Subsection (A) and further adjusted as provided under 113(b)(1)(a) which provides for adding or deducting from the 113(a) basis expenditures, receipts, losses or other items properly chargeable to capital account.

Section 113(a) [Internal Revenue Code, 113(a)] provides that the basis for determining gain or loss shall be (a) cost (a)(2) if acquired by gift after December 31, 1920, the same as it would be in the hands of the donor.

Section 113(8) (B) [Internal Revenue Code, 113(8)(B)] provides that property acquired by a corporation as paid-in surplus or as a contribution to capital, for the purpose of determining the basis of loss or gain, shall be the same as it would be in the hands of the transferor.

Depreciation deduction from taxable net income is a very familiar provision of the income tax statute but many complex factors enter into its determination. Like all other deductions, the allowance is a matter of legislative grace. The purpose of the Statute is to create a fund to restore the property to the extent of the investment of [fol. 58] the taxpayer at the end of its useful life. Basic to the allowance of depreciation is the determination of the capital sum to which the annual rate is to be applied. As will be noted from the enumerated sections of the Revenue Act on the subject, so far as the basic sum is to be determined, the sections of the statute authorizing the allowance are concatenated with the sections of the statute providing for the adjusted basis for the determination of gain or loss on the sale of capital assets.

The ultimate answer to the problem we have here is what would have been the basis for determining gain or loss had petitioner sold the assets in question. The cost of property to a taxpayer is the basis to be used in determining gain or loss from the sale or other disposition thereof, increased or decreased according to certain receipts, expenditures or losses chargeable to capital account.

When determining the cost of a depreciable asset not acquired by a purchase or exchange, but as we have here, from an aggregation of expenditures incurred in its creation, the expenditures, receipts, losses or other items, as the case may be, must be properly chargeable to the capital account which represents the depreciable property. All expenditures having some reasonable relationship to the asset are a part of its cost and likewise all receipts having some reasonable relationship to the asset, must be deducted from the cost.

The contributions made by the prospective users of petitioner's facilities had a direct relationship to the

cost thereof and, in determining petitioner's cost, such contributions must be deducted under the express provisions of Section 113(b)(1)(a) of the Act. Petitioner had no capital investment in the depreciable property here in question. *Southern Power & Mfg. Company* v. *Commissioner*, 82 F. (2d) 104 (C. C. A. 5); *Kell, et al.* v. *Commissioner*, 88 F. (2d) 453 (C. C. A. 5).

As the facts appear in the record, the refunds which petitioner had contracted to make to its customers who had contributed the cost of the erection of the facilities were too indefinite in amount and time of payment to be [fol. 59] capitalized as representative of their cost to the petitioner at the time such depreciable assets were constructed. There could then be no reasonable prediction as to the amount petitioner would ultimately refund. It is essential to the creation of an accruable liability or reserve that there be an agreement between the parties fixing the amount or that the amount due be determinable with reasonable certainty from the surrounding facts and circumstances. When the obligation is contingent, or indefinite as to amount, its accrual or payment is so uncertain that no charge can be made under any correct system of accounting. *United States* v. *Anderson*, 269 U. S. 422, 441; *Weiss* v. *Wiener*, 279 U. S. 333, 336; *Brown* v. *Helvering*, 291 U. S. 193, 205.

Section 113(a)(2) of the Act has no application to the facts in the case at bar. The contributions petitioner received under the contracts in question were neither gifts nor gratuities but were supported by considerations. *Louisville & Nashville Railroad Company* v. *United States*, 267 U. S. 395, 402; *Edwards* v. *Cuba Railroad Company*, 268 U. S. 628, 632.

A gift is a voluntary transfer of property by one to another without any consideration or compensation therefor. Under the contracts which were the source of the funds used to construct petitioner's improvements, it obligated itself to build the facilities and the contributors expected to obtain full remuneration by the use of the electric energy produced by petitioner.

Section 113(8)(B) of the Act is inapplicable to the case at bar. The phrase "paid-in surplus" is a term commonly employed in corporate financing and accounting, to designate an account on corporate books. The surplus account

represents the net assets of a corporation in excess of all liabilities, including its capital stock and such fund is available for distribution to the corporation's stockholders. None of the funds contributed by petitioner's customers under the contracts in question could have been used for the payment of dividends to petitioner's stockholders. They were for the express purpose of constructing improvements.

[fol. 60] The phrase "contribution to capital" as used in the Revenue Act is a term which as ordinarily understood when applied to private corporations means the fund or property contributed or agreed to be contributed by the share owners as the financial basis for the prosecution of the business of the corporation, such contributions being made either directly through stock subscriptions or indirectly through the transfer of property in exchange for a stock interest in the corporation. As thus used, the term signifies those resources whose dedication to the users of the corporation is made the foundation for the issuance of capital stock and which, as the result of the dedication, become irrevocably devoted to the satisfaction of all the obligations of the corporation. This conclusion is made clear when it is noted that Section 113(8) is in conjunction with the sections of the Act providing for transfers to corporations in connection with a reorganization. If petitioner had diverted the funds thus obtained to another purpose and had abandoned the project, the donors could have reclaimed their contributions. It is clear the contributions could not have been legally devoted to the satisfaction of all the obligations of the petitioner.

The Board reached the conclusion that the petitioner was entitled to include in its capital expenditures for depreciable assets, a sum equal to the amounts it had refunded to contributing customers in each year, over the useful life of the depreciable assets. Under the state of the record we are not called on to decide whether the refunds which petitioner made were capital expenditures having a reasonable relationship to the cost of a depreciable asset, or were ordinary and necessary business expenses. There is an essential difference between capital expenditures and deductions from gross income for ordinary and necessary expenses in carrying on a trade or business. Capital is a fund from which income flows or expenses arise. Since the Commissioner and the Board included in petitioner's de-

preciable capital account for each year the refunds made to petitioner's customers out of gross receipts, we are not [fol. 61] permitted to disturb that allowance even if it were incorrect. *Helvering* v. *Pfeiffer*, 302 U. S. 247, 251.

The conclusion here reached is in conflict with the case of *Arundel-Brooks Concrete Corporation* v. *Commissioner of Internal Revenue*, 129 F. (2d) 762 (C. C. A. 4), which is strongly relied on by petitioner. In our opinion the court in that case fell into error in not giving due weight to the concept that the elements of the taxing act in question do not stand independent and isolated from each other. They all combine to produce a specific rule for the determination of deductible depreciation. The word "cost" as used in Section 113(a) beyond question refers to the cost of the property to the taxpayer. This is made manifest when Section 113(a) is considered in the light of Subsection (2) which provides for a different base if the property is acquired by gift and also Subsection (8) (B) which provides for a different basis if property is acquired by a corporation as "paid-in surplus or as a contribution to capital."

The court in the cited case assumed that the word "cost" as used in the statute related to the property and was not confined to the cost of the property to the taxpayer. The case of *Nashville Warehouse & Elevator Corporation* v. *Commissioner*, 105 F. (2d) 883 (C. C. A. 6), also relied on by petitioner, is clearly distinguishable on its facts from the case at bar.

As we view it, neither the provisions of the Act in question nor the interpretative regulations may be read fairly to authorize the deductions claimed by petitioner.

Order of the Board is affirmed.

[fol. 62] Clerk's Certificate to foregoing transcript omitted in printing.

[fol. 63] SUPREME COURT OF THE UNITED STATES, OCTOBER TERM, 1942

No. 675

[Title omitted]

ORDER ALLOWING CERTIORARI—Filed March 1, 1943

The petition herein for a writ of certiorari to the United States Circuit Court of Appeals for the Sixth Circuit is granted.

And it is further ordered that the duly certified copy of the transcript of the proceedings below which accompanied the petition shall be treated as though filed in response to such writ.

The Chief Justice took no part in the consideration or decision of this application.

IN THE

Supreme Court of the United States

October Term, 1942.

No. 475

THE DETROIT EDISON COMPANY,
Petitioner,

against

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SIXTH CIRCUIT

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January, 1943.

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1942

THE DETROIT EDISON COMPANY,
Petitioner,

against

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

No. /

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SIXTH CIRCUIT

The above named petitioner prays that a writ of certiorari be issued to review the judgment (R. 53) of the United States Circuit Court of Appeals for the Sixth Circuit affirming the decision of the United States Board of Tax Appeals in the above entitled proceeding.

OPINIONS BELOW

The opinion of the Circuit Court of Appeals (R. 54-61) is not yet officially reported. The opinion of the Board of Tax Appeals (R. 42-47) is reported in 45 B. T. A. 358.

JURISDICTION

The judgment of the Circuit Court of Appeals sought to be reviewed was entered November 30, 1942. Jurisdiction to issue the writ requested is found in the provisions

of Section 240(a) of the Judicial Code, as amended by the Act of February 13, 1925.

STATUTE INVOLVED

The statute involved is the Revenue Act of 1936, Ch. 690, 49 Stat. 1648, the pertinent provisions of which are as follows:

"SEC. 23. DEDUCTIONS FROM GROSS INCOME.

"In computing net income there shall be allowed as deductions:

* * *

"(1) *Depreciation.*—A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence. * * *

* * *

"(*n*) *Basis for depreciation and depletion.*—The basis upon which depletion, exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be as provided in section 114."

"SEC. 114. BASIS FOR DEPRECIATION AND DEPLETION.

"(*a*) *Basis for depreciation.*—The basis upon which exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be the adjusted basis provided in section 113 (b), for the purpose of determining the gain upon the sale or other disposition of such property."

"SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

"(*a*) *Basis (unadjusted) of property.*—The basis of property shall be the cost of such property; except that—

* * *

"(2) *Gifts after December 31, 1920.*—If the property was acquired by gift after December 31,

1920, the basis shall be the same as it would be in the hands of the donor or the last preceding owner by whom it was not acquired by gift, except that for the purpose of determining loss the basis shall be the basis so determined or the fair market value of the property at the time of the gift, whichever is lower.

* * *

"(4) *Gift or transfer in trust before January 1, 1921.*—If the property was acquired by gift or transfer in trust on or before December 31, 1920, the basis shall be the fair market value of such property at the time of such acquisition.

* * *

"(8) *Property acquired by issuance of stock or as paid-in surplus.*—If the property was acquired after December 31, 1920, by a corporation—

* * *

(B) as paid-in surplus or as a contribution to capital,

then the basis shall be the same as it would be in the hands of the transferor, * * *.

* * *

"(b) *Adjusted basis.*—The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis determined under subsection (a), adjusted as hereinafter provided.

"(1) *General rule.*—Proper adjustment in respect of the property shall in all cases be made—

"(A) for expenditures, receipts, losses, or other items, properly chargeable to capital account, including taxes and other carrying charges on unimproved and unproductive real property, but no such adjustment shall be made

for taxes or other carrying charges for which deductions have been taken by the taxpayer in determining net income for the taxable year or prior taxable years;"

Treasury Regulations 94, promulgated under the Revenue Act of 1936, provide with respect to Section 113(a) (8) (B):

"Art. 113(a) (8)-1. Property acquired by a corporation after December 31, 1920.— * *

"In respect of property acquired by a corporation after December 31, 1920, from a shareholder as paid-in surplus, or from any person as a contribution to capital, the basis of the property in the hands of the corporation is the basis which the property would have had in the hands of the transferor if the transfer had not been made. * * *"

QUESTION PRESENTED

What is the basis for depreciation for Federal income tax purposes of depreciable business property that is constructed by an owner who receives a cash payment from a non-stockholder as a condition precedent to the construction and operation of such property? Is the depreciation basis (a) the actual cost of construction or (b) the cost of construction reduced on account of the payment received from the non-stockholder?

STATEMENT

Petitioner is a public utility corporation of New York, licensed to do business in Michigan, and is engaged in generating and selling electric energy in the City of Detroit and surrounding territory and operates under the jurisdiction of the Michigan Public Service Commission. (R. 20.)

Petitioner, in connection with the distribution and sale of electric energy, from time to time receives applications for extension of its transmission and/or distribution lines to places which, in petitioner's opinion, are situated too far from its existing lines to warrant the expenditure of the amounts necessary to make such extensions. In such cases petitioner, prior to the construction of the desired extensions, requires the applicants to pay to it sums representing the estimated cost per mile for construction of such extension, which is agreed to in writing. (R. 20.) The amount paid by each applicant, which never exceeds the actual cost of construction, is final as to such applicant regardless of the actual cost of construction, except that under his contract he may become entitled to a refund upon the happening of certain events. (R. 20-21.)

The agreement between the petitioner and each applicant is evidenced by one of five standard types of contract. (R. 20, 29-42.) Under contracts of the first four types, the applicant becomes entitled to receive during the first five years following completion of the extension a refund of a sum up to but not exceeding the amount of his payment, computed in accordance with the formula depending for its operation upon either (1) the number of additional customers who subscribe for service over the particular line extension or (2) the gross revenue received from such line extension. Under contracts of the fifth type, the applicant is entitled to no refund. Under petitioner's rules, filed with the Michigan Public Service Commission, and printed on the reverse side of each contract, the applicant is permitted to build the line extension himself, if he chooses, and then turn them over to petitioner.

Material and labor used in the construction of the line extensions are paid from the general working funds of the petitioner and it makes in its books of accounts entries identifying all work performed under the provisions of each respective contract. (R. 21.)

Upon completion of a line extension, petitioner in accordance with standard practice enters upon its books as a property item the cost of the line extension including labor and material and does not subtract from that sum the amount of the payment made by the applicant. (R. 21.)

The cash payments received from applicants are not earmarked in petitioner's accounts for the construction of line extensions, but the sums received become part of petitioner's free working capital and are carried in petitioner's accounts accordingly. (R. 21.)

Petitioner's accounting procedure is in accordance with the Uniform Classification of Accounts for Electric Utilities prescribed by the Michigan Public Service Commission. (R. 21-23.) This procedure is as follows: Upon receipt of a payment from an applicant, petitioner debits its cash account and credits one of the special liability accounts referred to below with the amount thereof. In the case of payments subject to possible refund, the payments are credited to a special liability account entitled "Customers Deposits for Line Extensions", classified under account No. 261 entitled "Miscellaneous Unadjusted Credits"; and upon the expiration of the period for refund any unrefunded balance is transferred from account No. 261 to special liability account No. 255 entitled "Contributions for Extensions". In the case of payments not subject to refund, the payments are credited in the first instance to account No. 255. Upon construction of a line extension

owned by it, petitioner credits its cash account and correspondingly debits its property account. Depreciation on the line extension is currently credited to depreciation reserve and debited to depreciation, which is an operating expense entering into profit and loss account. Upon retirement of a line extension, depreciation reserve is debited and the property account credited. No adjustment is made to special liability accounts Nos. 261 or 255 in connection with the construction, depreciation or retirement of a line extension.*

After completion of a line extension, petitioner is under a legal duty, at its own expense, to keep and maintain the line extension in good repair and working order, and to replace the same in whole or in part as and when necessary, so that service will at all times be available therefrom. (R. 25.)

During the years 1936 and 1937, applicants' payments in the amounts of $36,065.81 and $47,500.67, respectively, were received subject to no refund or became unrefundable by virtue of the expiration of the period for refund. Petitioner did not report these amounts as income and respondent did not attempt to subject them to Federal income tax.

In its returns for 1936 and 1937, petitioner claimed depreciation deductions at approved rates upon its line extensions at their cost of construction as shown by its books,

*The Court and the Board erroneously assumed that when the period for refund expires all remaining balances in these accounts are credited to Surplus. Transfers to Surplus were in fact made only in 1932, 1933 and 1934. (R. 24.) These transfers were approved by the Michigan Public Service Commission on the understanding that for rate making purposes the amounts transferred would be included in income for the years in which the payments were received. *Re The Detroit Edison Company*, 16 P. U. R. (N. S.) 59 (Michigan, 1936).

without any deduction for amounts paid by applicants. Respondent disallowed a portion of such deductions on the ground that the basis upon which such depreciation deductions is to be calculated is the amount expended in construction of the line extensions diminished by the total amount paid by applicants under contracts providing for no refunds, and by the mean between the beginning and end of each year of the unrefunded balances of amounts paid by applicants under contracts providing for refunds and with respect to which the period for refund had expired. (R. 25-26.) He used this formula irrespective of whether the particular line extensions in respect of which the payments were made were still in existence.

The amount of depreciation deductions in dispute is $40,273.11 for the year 1936 and $41,786.26 for the year 1937 (R. 26) and the amount of income tax liability in dispute for said years is $4,031.04 and $6,267.94, respectively. (R. 6.)

The Board of Tax Appeals sustained the respondent (R. 47), and on appeal the Circuit Court of Appeals for the Sixth Circuit affirmed (R. 53).

SPECIFICATION OF ERRORS TO BE URGED

The Circuit Court of Appeals erred:

1. In holding that the funds utilized by petitioner in constructing its line extensions can be traced and that their source is material in determining the cost to petitioner and its basis for depreciation of the line extensions.

2. In holding that payments received by petitioner from prospective customers upon applications for construction of line extensions constituted "receipts" to be deducted

under Section 113(b)(1)(A) of the Revenue Act of 1936 in determining petitioner's cost and basis for depreciation of its line extensions; and in failing to hold that such payments, if their status was material, constituted contributions to capital within the meaning of Section 113(a)(8)(B), or gifts, or consideration received for obligations of equal value assumed, as would clearly have been the case if the line extensions had been built by the applicants and then turned over to petitioner.

3. In holding that capital contributions can be made only by shareholders, and in thus disregarding the express provision of Article 113(a)(8)-1 of Regulations 94 that property may be received by a corporation "from any person as a contribution to capital."

4. In holding that capital contributions cannot be made for a specific purpose.

5. In holding that petitioner's basis for depreciation and its depreciation deductions for 1936 and 1937 in respect of line extensions constructed and owned by it and used in its business should be reduced on account of payments made to it by prospective customers on applications for construction of line extensions.

6. In affirming the decision of the United States Board of Tax Appeals.

REASONS FOR GRANTING THE WRIT

1.

The Circuit Court of Appeals for the Sixth Circuit has decided an important Federal tax question in direct conflict with the decision of the Circuit Court of Appeals for the Fourth Circuit in *Arundel-Brooks Concrete Corpora-*

tion v. *Commissioner*, 129 F. (2d) 762. This is expressly pointed out in the opinion below, wherein the Court said (R. 61): "The conclusion here reached is in conflict with the case of *Arundel-Brooks Concrete Corporation* v. *Commissioner of Internal Revenue*, 129 F. (2d) 762 (C. C. A. 4), which is strongly relied on by petitioner."

In the latter case, Arundel-Brooks Concrete Corporation constructed for $40,000 a concrete mixing plant at Sparrows Point, Maryland, in order to supply Bethlehem Steel Company with concrete necessary for new construction. Maryland Slag Company contributed $20,000 toward the construction cost, it being in its interest to do so since it had a contract with Bethlehem Steel Company to remove, process and market slag from the latter's blast furnaces at Sparrows Point and processed slag was used in making concrete. The Commissioner claimed that Arundel-Brooks Concrete Corporation had a depreciation basis for the new plant of only $20,000 and the Board of Tax Appeals sustained him. The Circuit Court of Appeals for the Fourth Circuit reversed the Board and held that the corporation's basis for depreciation of the plant was the $40,000 actually expended in the building thereof and not that sum less the $20,000 contributed by Maryland Slag Company toward the cost of construction. The Court found it unnecessary to determine with legal exactness the precise nature of the $20,000 contribution (the briefs had not presented the question whether it was a contribution to capital), since " 'cost' * * * would remain the same regardless of the source of the funds from which payment was made."

In the present case, the Circuit Court of Appeals for the Sixth Circuit has held that the petitioner's basis for depreciation of its line extensions was not the amount

expended by it in their construction but was that amount less certain amounts contributed by prospective customers toward the cost of construction. The Court ruled that the contributions were not gifts because supported by considerations, that they were not contributions to capital or paid-in surplus because the contributions were not made by shareholders and were for the specific purpose of constructing improvements but that they constituted "receipts" which must be deducted under Section 113(b)(1)(A) of the statute in determining petitioner's cost.

In ruling that the contributions were supported by considerations and therefore did not constitute gifts, the decision is probably inconsistent with the decision of the Circuit Court of Appeals for the Seventh Circuit in *American Dental Company* v. *Commissioner*, 128 F. (2d) 254, certiorari granted October 12, 1942.

In ruling that the contributions were supported by considerations and failing to recognize the value of such considerations as their "cost", the decision is probably in conflict with the decision of the Circuit Court of Appeals for the Ninth Circuit in *Robinson* v. *Commissioner*, 97 F. (2d) 552, affirming 35 B. T. A. 1080. There the owner of a public utility entered into contracts, with the approval of the Railroad Commission of California, whereby he received from the subdividers of certain land title to water mains, pipes and other connections, to be installed by the subdividers or at their expense, in consideration for which he agreed to maintain the property so received and to furnish at regular rates an adequate supply of water to consumers in the subdivision. The basic question in the case was the cost of the property to the public utility owner; and both the Board and the Court held that the value of his

agreements, constituting his cost of the property, was the value of that property since it was given to him in return for his agreements in a transaction entered into between parties dealing at arm's length.

2.

The Circuit Court of Appeals has decided an important Federal tax question in a way probably in conflict with the views expressed by this Court in *Edwards* v. *Cuba Railroad Company*, 268 U. S. 628.

Edwards v. *Cuba Railroad Company* involved the taxability as income of money subsidies granted by the Cuban Government to a railroad company to promote construction of a railroad in Cuba and coincidentally to obtain reduced rates and other privileges. The subsidies were fixed and paid proportionately to mileage actually constructed and were used by the company for capital expenditures but were not used to reduce the actual cost of construction as carried on the books. In addition to the money subsidies the Cuban Government also contributed certain lands and other physical property in aid of completion of the railroad. The Treasury sought to tax the money but not the property. This Court, stating that the subsidies of neither kind were received as mere gratuities, held that they were not income and indicated that they were capital contributions, saying:

> "The subsidy payments were proportionate to mileage completed; and this indicates a purpose to reimburse plaintiff for capital expenditures. All—the physical properties and the money subsidies—were given for the same purposes. It cannot reasonably be held that one was contribution to capital assets, and that the other was profit, gain or income."

There, as here, the subsidies were received from non-stockholders and for the specific purpose of constructing property. Yet this Court considered them capital contributions.

There, this Court thought that contributions in money and physical properties for similar purposes should be treated alike. Here, if the line extensions themselves had been contributed to petitioner in lieu of cash as petitioner's rules permitted (R. 29-42), they obviously would not have constituted receipts serving to reduce the cost of any of petitioner's assets under Section 113(b)(1)(A). Yet the Circuit Court of Appeals would apparently distinguish between the treatment of cash and property contributions for the same purposes, since it has here applied Section 113(b)(1)(A) to the receipt of the cash.

3.

The Circuit Court of Appeals has decided an important Federal tax question in a way that is probably in conflict with decisions of this Court including *Helvering* v. *Wilshire Oil Co., Inc.*, 308 U. S. 90, and *Helvering* v. *R. J. Reynolds Tobacco Co.*, 306 U. S. 110.

These cases require that unambiguous Treasury Regulations, not in conflict with the statute, and in force through successive reenactment of the statute, have the force of law so long as they remain outstanding.

Article 113(a)(8)-1 of Regulations 94, promulgated under the Revenue Act of 1936, expressly provides that property may be received "from a shareholder as paid-in surplus, or from any person as a contribution to capital". This quoted language has been contained in the Treasury Regulations through successive reenactments of the statute continuously since 1934. Article 113(a)(8)-1 of Regu-

lations 86, 94 and 101; Section 19.113(a)(8)-1 of Regulations 103. Identical language is contained in the recently issued Excess Profits Tax Regulations 109, Section 30.718-1, and in Bulletin "F" (Revised January, 1942) of the Internal Revenue Bureau. This provision of the regulations, which doubtless stems from just such cases as *Edwards* v. *Cuba Railroad Company*, now has the force of law. Yet the Circuit Court of Appeals has ignored it and has ruled that the payments made by petitioner's prospective customers could not constitute contributions to capital since they were not made by shareholders.

4.

The Circuit Court of Appeals has decided an important Federal tax question in a way that is probably in conflict with its own prior decision in *Nashville Warehouse & Elevator Corporation* v. *Commissioner*, 105 F. (2d) 883, a case which the Court thought distinguishable but which the Circuit Court of Appeals for the Fourth Circuit in *Arundel-Brooks Concrete Corporation* v. *Commissioner* said was persuasively analogous.

In *Nashville Warehouse & Elevator Corporation* v. *Commissioner*, the taxpayer purchased elevator property for $40,000 payable in installments and paid all but $12,733.67 of the purchase price out of the proceeds of fire insurance collected upon the destruction of the property by fire. The Commissioner contended that the cost of the property to the taxpayer was $12,733.67, not $40,000. But the Court answered this by saying: "Obviously the full item should be included in figuring the cost of the property. Whatever the source of the funds from which payment was made, the cost was $40,000."

The decision of the Circuit Court of Appeals here was essentially based upon tracing the source of the moneys used by petitioner in constructing its line extensions. Petitioner argued that the funds so used were not traceable and that even if they were their source—whether from earnings, loans, capital contributions, gifts or otherwise—was wholly immaterial. But the Court rejected this argument and held that the funds constituted receipts to be deducted from actual cost of construction in determining petitioner's cost for depreciation purposes.

5.

The Circuit Court of Appeals has decided an important question of Federal tax law which has not been, but should be, settled by this Court. Money and property contributions and subsidies to corporations from third parties for specific purposes in the mutual interests of all concerned are not uncommon. The status of such contributions and subsidies as respects their taxability as income has been settled by this Court in *Edwards* v. *Cuba Railroad Company*, which has been uniformly followed in a long line of cases.

The equally important question as to the effect of such cash contributions upon the basis of the property constructed therewith, and as to the basis of property directly contributed, has not been settled. The decisions below are in conflict and confusion and, unless now settled, much further litigation seems inevitable. Not only is the present dispute with owners of such property sure to recur, but business concerns making contributions to procure construction may be expected, as indeed has recently been publicly suggested (Alexander Tax News Letters, December 11 and

18, 1942), to claim the benefit of the depreciation deductions if and to the extent denied the owner, notwithstanding that the contributor has no continuing right or interest in any particular property constructed and notwithstanding that such rights as he possesses continue indefinitely through successive renewals and replacements of the original property at the owner's expense.

The statute recognizes the fundamental principle that depreciation sustained through use of property in a business is one of the natural and ordinary expenses of doing business, and that profits cannot be determined until depreciation is taken into account. It undertakes to cover in detail the whole field of allowances for depreciation and the depreciation basis, however the property may have been acquired. Congress was concerned with the fact that it is the property itself that depreciates; and it provided for a continuity of the depreciation basis and gave a new basis only when an owner, paying a consideration, ought not to be tied to someone else's cost.

If a taxpayer owns a plant, the basis for computing depreciation on it under the statute depends upon whether it was acquired for a consideration or without a consideration. If the taxpayer built it or otherwise acquired it for a consideration, the depreciation basis is the amount or value of the consideration given for it by the taxpayer, which would be its cost; and this would be true irrespective of whether the money utilized for that purpose was derived from capital, earnings, borrowing, gifts or any other source. If the taxpayer gave no consideration and accordingly received the plant as a gift or as a contribution to capital, the depreciation basis would continue to be the same as in the hands of the transferor. The operation of the plant of neces-

sity consumes it over its useful life and hence depreciation is allowed.

Here, inescapably, the line extensions were acquired by petitioner either for a consideration or without a consideration. If acquired for a consideration, the amount or value of that consideration is petitioner's basis for depreciation under Section 113(a) of the statute. If acquired without a consideration on the theory that they were in effect contributed by the prospective customers, then the petitioner took over the latter's basis under Section 113 (a) (2) or (8) (B). Under either of these theories — alternatives covering the whole field — the result is the same: the petitioner's depreciation basis for the line extensions is what it cost to construct them.

Section 113(b)(1)(A) has no more to do with the matter, and no different effect upon such basis, than if the line extensions had been built by the prospective customers in the first instance and then turned over to the petitioner. The cash contributions, when expended for capital assets, served to increase capital account to exactly the same extent as if there had been a contribution of the property itself. In either case the basis for depreciation would be the same under the scheme of the statute.

Section 113(b)(1)(A) merely contains the expected requirement that adjustment in respect of property must be made for items "properly chargeable to capital account". This provision was clearly intended to cover subsequent capital expenditures on the property and possibly also such items as sale of part of the property, adjustment of the purchase price and items of that kind. But it would beg the question to say that this section is determinative here, for the primary questions would still be open for decision,

namely, the legal status of the funds petitioner received and the right to trace and materiality of the source of the funds used in the construction.

In view of the conflict that has developed on this subject and of its broad importance, the meaning and spirit of the statute are urgently in need of clarification by this Court.

WHEREFORE your petitioner prays that its petition be granted and that a writ of certiorari be issued to review the judgment herein of the Circuit Court of Appeals for the Sixth Circuit.

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January, 1943.

FILE COPY

IN THE

Supreme Court of the United States

OCTOBER TERM, 1942

No. 675

THE DETROIT EDISON COMPANY,
Petitioner,

against

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

BRIEF ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SIXTH CIRCUIT

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March, 1943.

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1942

THE DETROIT EDISON COMPANY, *Petitioner,* *against* COMMISSIONER OF INTERNAL REVENUE, *Respondent.*	No. 675

BRIEF ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SIXTH CIRCUIT

This case comes up on a writ of certiorari granted March 1, 1943 (R. 55) to review the judgment (R. 47) of the United States Circuit Court of Appeals for the Sixth Circuit affirming the decision (R. 42) of the United States Board of Tax Appeals (now The Tax Court of the United States) in the above entitled proceeding.

OPINIONS BELOW

The opinion of the Circuit Court of Appeals (R. 47-54) is reported in 131 F. (2d) 619. The opinion of the Board of Tax Appeals (R. 38-42) is reported in 45 B. T. A. 358.

JURISDICTION

The judgment of the Circuit Court of Appeals sought to be reviewed was entered November 30, 1942. Jurisdic-

tion is found in the provisions of Section 240(a) of the Judicial Code, as amended by the Act of February 13, 1925.

STATUTE INVOLVED

The statute involved is the Revenue Act of 1936, Ch. 690, 49 Stat. 1648, the pertinent provisions of which are set forth in the Appendix.

QUESTION PRESENTED

Is the basis for depreciation for Federal income tax purposes of depreciable business property that is constructed by the owner to be changed by the fact that the owner receives a cash payment from a non-stockholder as a condition precedent to the construction and operation of such property,—the owner upon such construction being required by law indefinitely to maintain the property and furnish electric energy upon demand at regular rates to the non-stockholder and others adjacent to the property? Is the depreciation basis (a) the actual cost of construction or (b) the cost of construction reduced on account of the payment received from the non-stockholder?

STATEMENT

Petitioner is a public utility corporation of New York, licensed to do business in Michigan, and is engaged in generating and selling electric energy in the City of Detroit and surrounding territory and operates under the jurisdiction of the Michigan Public Service Commission (R. 15-16).

Petitioner, in connection with the distribution and sale of electric energy, from time to time receives applications for extension of its transmission and/or distribution lines to places which, in petitioner's opinion, are situated too far

from its existing lines to warrant the expenditure of the amounts necessary to make such extensions. In such situations, two alternative procedures are in general available to an applicant. He may either build the desired extension himself and then turn it over to the petitioner, or if he chooses he may pay the petitioner a sum of money whereupon the petitioner will build the extension. These alternative procedures are specified in the petitioner's rules, filed with the Michigan Public Service Commission and printed on the reverse side of the regular line extension agreements (R. 24, 27), and the accounting is done under the regulations of the Commission. We here have to deal only with a situation where the second alternative is adopted, but it is well to note the existence of both alternatives for, as we shall point out hereinafter, the tax consequences ought to be the same regardless of the alternative adopted.

Where, as here, the applicant selects the second alternative, petitioner, as a condition precedent to the construction of the desired extension, requires the applicant to pay to it a sum representing the estimated cost per mile for construction of such extension, which payment is agreed to in writing (R. 16). The amount paid by each applicant, which never exceeds the actual cost of construction, is final as to such applicant regardless of the actual cost of construction, except that under his contract he may become entitled to a refund upon the happening of certain events (R. 16, 18-19).

The agreement between the petitioner and each applicant is evidenced by one of five standard types of contract (R. 16, 21-37). Under contracts of the first four types, the applicant becomes entitled to receive during the first five years following completion of the extension a refund

of a sum up to but not exceeding the amount of his payment, computed in accordance with a formula depending for its operation upon either (1) the number of additional customers who subscribe for service over the particular line extension or (2) the gross revenue received from such line extension. Under contracts of the fifth type, the applicant is entitled to no refund.

The cash payments received from applicants are not earmarked in petitioner's accounts for the construction of line extensions, but the sums received become part of petitioner's free working capital and are carried in petitioner's accounts accordingly (R. 17).

Material and labor used in the construction of the line extensions are paid from the general working funds of the petitioner and it makes in its books of accounts entries identifying all work performed under the provisions of each respective contract (R. 16).

Upon completion of a line extension, petitioner in accordance with standard practice enters upon its books as a property item the cost of the line extension including labor and material and does not subtract from that sum the amount of the payment made by the applicant (R. 17).

Petitioner's accounting procedure is in accordance with the Uniform Classification of Accounts for Electric Utilities prescribed by the Michigan Public Service Commission (R. 17-18). This procedure is as follows: Upon receipt of a payment from an applicant, petitioner debits its cash account and credits one of the special accounts referred to below with the amount thereof. In the case of payments subject to possible refund, the payments are credited to a special account entitled "Customers Deposits for

Line Extensions", classified under account No. 261 entitled "Miscellaneous Unadjusted Credits"; and upon the expiration of the period for refund any unrefunded balance is transferred from account No. 261 to special account No. 255 entitled "Contributions for Extensions". In the case of payments not subject to refund, the payments are credited in the first instance to account No. 255. Upon construction of a line extension, petitioner credits its cash account and correspondingly debits its property account. Depreciation on the line extension is currently credited to depreciation reserve and debited to depreciation, which is an operating expense entering into profit and loss account. Upon retirement of a line extension, depreciation reserve is debited and the property account credited. No adjustment is made to special accounts Nos. 261 or 255 in connection with the construction, depreciation or retirement of a line extension.[1]

After completion of a line extension, petitioner is under a legal duty, at its own expense, to keep and maintain the line extension in good repair and working order, and to replace the same in whole or in part as and when necessary, so that service will at all times be available therefrom (R. 20).

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[1] The Court and the Board erroneously assumed that when the period for refund expires all remaining balances in these accounts are credited to Surplus. Transfers to Surplus were in fact made only in 1932, 1933 and 1934 (R. 19). These transfers were approved by the Michigan Public Service Commission on the understanding that for rate making purposes the amounts transferred would be included in income for the years in which the payments were received. *Re The Detroit Edison Co.*, 16 P.U.R. (N.S.) 59 (Michigan, 1936).

During the years 1936 and 1937, applicants' payments in the amounts of $36,065.81 and $47,500.67, respectively, were received subject to no refund or became unrefundable by virtue of the expiration of the period for refund. Petitioner did not report these amounts as income and respondent did not attempt to subject them to Federal income tax (R. 20).

In its returns for 1936 and 1937, petitioner claimed depreciation deductions at approved rates upon its line extensions at their cost of construction as shown by its books, without any reduction for amounts paid by applicants. Respondent disallowed a portion of such depreciation deductions on the ground that the basis upon which depreciation is to be calculated is the amount expended in construction of the line extensions diminished by the total amount paid by applicants under contracts providing for no refunds, and by the mean between the beginning and end of each year of the unrefunded balances of amounts paid by applicants under contracts providing for refunds and with respect to which the period for refund had expired (R. 9-10, 20-21). He used this formula irrespective of whether the particular line extensions in respect of which the payments were made were still in existence.

The amount of depreciation deductions in dispute is $40,273.11 for the year 1936 and $41,786.26 for the year 1937 (R. 21).

The Board of Tax Appeals sustained the respondent (R. 42), and on appeal the Circuit Court of Appeals for the Sixth Circuit affirmed (R. 47).

SPECIFICATION OF ERRORS TO BE URGED

The Circuit Court of Appeals erred:

1. In holding that the funds utilized by petitioner in constructing its line extensions can be traced and that their source is material in determining the cost to petitioner and its basis for depreciation of the line extensions.

2. In holding that payments received by petitioner from prospective customers upon applications for construction of line extensions constituted "receipts" to be deducted under Section 113(b)(1)(A) of the Revenue Act of 1936 in determining petitioner's cost and basis for depreciation of its line extensions; and in failing to hold that such payments, if their status was material, constituted contributions to capital within the meaning of Section 113(a)(8)(B), or gifts within the meaning of Section 113(a)(2), or consideration received for obligations of equal value assumed, as would clearly have been the case if the line extensions had been built by the applicants and then turned over to petitioner as petitioner's rules permitted.

3. In holding that there was consideration for the contributions so as to prevent them from being gifts and then failing to follow through consistently by giving effect to the value of such consideration as the purchase price.

4. In holding that capital contributions can be made only by shareholders, and in thus disregarding the express provision of Article 113(a)(8)-1 of Regulations 94 that property may be received by a corporation "from any person as a contribution to capital".

5. In holding that capital contributions cannot be made for a specific purpose.

6. In holding that petitioner's basis for depreciation and its depreciation deductions for 1936 and 1937 in respect of line extensions constructed and owned by it and used in its business should be reduced on account of payments made to it by prospective customers on applications for construction of line extensions.

7. In affirming the decision of the United States Board of Tax Appeals.

SUMMARY OF ARGUMENT

1. The line extensions in question are property (a) constructed and owned by the petitioner, (b) used by it in the conduct of its business and (c) with a limited useful life. These facts are admitted, and the petitioner is therefore entitled to depreciation allowances under the provisions of the governing revenue act, the only remaining factor being the proper depreciation basis.

2. In determining petitioner's cost of the line extensions, the Board and the Circuit Court of Appeals sought to look to the source of the funds utilized in their construction, thereby adopting a criterion that is unsound and wholly irrelevant. The funds used in constructing the line extensions cannot be traced; but even if traceable, the source of the construction funds is wholly immaterial in determining the cost of the extensions under the generally accepted and administratively essential income tax rule. The amount expended establishes the cost, whether the funds came from original capital, earnings, borrowings, contributions to capital, gifts or any other source.

3. The controlling rule must be found in the statute. Necessarily the petitioner gave a consideration for the line extensions or it gave no consideration; there is no possible middle ground. If it gave a consideration, the amount or value of that consideration is its cost and basis for depreciation. If it gave no consideration on the theory that the extensions were in effect contributed by prospective customers, it must necessarily have acquired them as gifts or as contributions to capital in which event under the statute its depreciation basis would be the transferors' cost. On either premise, the petitioner's basis for depreciating the line extensions is the same—the amount expended on their construction.

4. The Court below, prior to this Court's decision of March 1, 1943 in *Helvering* v. *American Dental Co.*, said the contributions were not gifts because there was consideration for them, but it failed to follow through consistently. For if the contributions were acquired for a consideration they were bought; they could not be "receipts" properly chargeable to capital account under Section 113(b)(1)(A), as held below, any more than they could be gifts.

5. The correct view is that the cash contributions increased capital account, and when expended on the line extensions served to increase the basis thereof, to exactly the same extent as if there had been a contr bution of the property itself, as petitioner's rules permitted. If an applicant builds a line extension and then contributes it to petitioner in lieu of cash, the contribution cannot reduce the basis of any of petitioner's property by adjustment of the unadjusted basis under Section 113(b)(1)(A). Obviously, the basis for petitioner's other property would not be

affected. A single property contribution cannot create a basis and an adjustment of it as well. This demonstrates the Court's error in applying the cash contributions in reduction of basis of the line extensions under Section 113(b)(1)(A), for contributions in cash and in property for identical purposes must necessarily be treated similarly.

6. The Board of Tax Appeals was obviously influenced, and the Circuit Court of Appeals may have been, by an assumption that if the claimed depreciation were allowed the petitioner would obtain an undue or double benefit. Actually petitioner would obtain no such benefit, indeed no benefit at all. But even if it did, the question of double benefit, like double taxation, lies with Congress; and the petitioner, the Commissioner and the Courts must take the statute as they find it and may not read into it something which is not only not there but which is in fact inconsistent with its terms.

ARGUMENT

I

PETITIONER'S COST OF THE LINE EXTENSIONS IS THE AMOUNT EXPENDED ON THEIR CONSTRUCTION AND THAT AMOUNT IS THE BASIS FOR DEPRECIATION THEREOF UNDER THE STATUTE. THE CONSTRUCTION FUNDS ARE NOT TRACEABLE AND EVEN IF THEY ARE THEIR SOURCE IS IMMATERIAL.

Money and property contributions and subsidies to corporations from third parties for specific purposes in the mutual interests of all concerned are not uncommon. That such contributions and subsidies are not taxable as income has been settled by this Court in *Edwards* v. *Cuba*

Railroad Co., 268 U. S. 628 (1925), which has been uniformly followed in a long line of cases.[2] The equally important question as to the effect of such cash contributions upon the basis for depreciation of the property constructed therewith, and as to the basis for depreciation of property directly contributed, is now presented to this Court in order to settle a conflict in the decisions below.

For Federal income tax purposes, depreciation deductions on the full cost of line extensions constructed with the aid of such contributions were once allowed without question and only the taxability of the payments was disputed. *Tampa Electric Co.*, 12 B. T. A. 1002; *Frank Holton & Co.*, 10 B. T. A. 1317. Indeed, the leading cases involving the nontaxability of subsidies and consumers' contributions expressly pointed out that cost of construction and plant account were not reduced by the amounts

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[2] These cases include the following: (a) Electric Utilities: *Liberty Light & Power Co.*, 4 B.T.A. 155; *Rio Electric Co.*, 9 B.T.A. 1332; *Wisconsin Hydro-Electric Co.*, 10 B.T.A. 933; *Tampa Electric Co.*, 12 B.T.A. 1002. (b) Others: *Great Northern Railway Co.*, 8 B.T.A. 225, 271, petition to review dismissed 40 F. (2d) 372 (C.C.A. 8th); *Aransas Compress Co.*, 8 B.T.A. 155; *Texas & Pacific Railway Co.*, 9 B.T.A. 365, *Atlantic Coast Line Railroad Co.*, 9 B.T.A. 1193; *El Paso Electric Railway Co.*, 10 B.T.A. 79; *Frank Holton & Co.*, 10 B.T.A. 1317; *Kauai Railway Co.*, 13 B.T.A. 686; *Kansas City Southern Railway Co.*, 16 B.T.A. 665, 687, appealed on other points 52 F. (2d) 372 (C.C.A. 8th); *Midland Valley Railroad Co.*, 19 B.T.A. 423, appealed on other points 57 F. (2d) 1042 (C.C.A. 10th); *Union Pacific Railroad Co.*, 26 B.T.A. 1126, appealed on other points 69 F. (2d) 67, 69 F. (2d) 966 (C.C.A. 2d), 293 U. S. 282; *Southern Railway Co.*, 27 B.T.A. 673, appealed on other points 74 F. (2d) 887, 80 F. (2d) 884 (C.C.A. 4th); *Baltimore & Ohio Railroad Co.*, 30 B.T.A. 194; *Valley Waste Disposal Co.*, 38 B.T.A. 452; *Decatur Water Supply Co.* v. *Commissioner*, 88 F. (2d) 341 (C.C.A. 7th); *Arundel-Brooks Concrete Corp.* v. *Commissioner*, 129 F. (2d) 762 (C.C.A. 4th).

received. *Edwards* v. *Cuba Railroad Co., supra; Liberty Light & Power Co.*, 4 B. T. A. 155. In this case, however, the Circuit Court of Appeals and the Board, recognizing the long settled rule that the contributions did not constitute taxable income, thought with the Commissioner that the petitioner's cost of the line extensions should be reduced on account of the contributions and by differing reasoning reached that result.

Section 23 (1) of the Revenue Act of 1936, which governs the years in question, and Article 23 (1) of Regulations 94 promulgated under that Act, specifically authorize depreciation allowances in respect of property (a) owned by the taxpayer, (b) used in its business and (c) having a limited useful life. These criteria are admittedly present here, and the only other factor is the basis on which the depreciation allowances are to be calculated.

The pertinent basis provisions of the 1936 Act are contained in Sections 113 and 114 of the Act, set forth in the Appendix. Under these provisions, the basis of property for the purpose of calculating depreciation allowances is the cost of such property, with certain exceptions not material to the discussion at this point but which will be referred to later.

(1)

The petitioner contends that the amount it expended on construction of the line extensions constitutes its cost of the extensions just as fully and effectively as if no contributions had been received from prospective customers.

It constructed the extensions with its own materials and labor, making the cash expenditure therefor from its general working funds; and it did so without regard to the

adequacy or inadequacy of the contributions. No specific use was made of the money contributed; it was not required to be, and was not, earmarked; it became a part of the petitioner's free working capital; it was deposited in the petitioner's general bank account and intermingled with its other funds; and it cannot be traced.

Even if the funds used by petitioner in constructing the line extensions were traceable, their source—whether from earnings, loans, capital contributions, gifts or otherwise—is wholly immaterial. There is no authority in the law for tracing funds in determining the cost of property; it is enough that the owner paid out its own money for it, however the money was obtained. The receipt and the payment out of corporate funds have always been considered separate and independent transactions under the tax laws, even though from an economic standpoint the one might not be possible without the other. If the rule were otherwise, an impossible complexity would be introduced into tax administration.

(2)

In holding that the petitioner's basis for depreciation of its line extensions was not the amount expended by it in their construction but was that amount less certain amounts contributed by prospective customers toward the cost of construction, the decision below is in direct conflict with the decision of the Circuit Court of Appeals for the Fourth Circuit in *Arundel-Brooks Concrete Corp.* v. *Commissioner*, 129 F. (2d) 762. This the Court below expressly recognized. In that case, Arundel-Brooks Concrete Corporation constructed for $40,000 a concrete mixing plant at Sparrows Point, Maryland, in order to supply

Bethlehem Steel Company with concrete necessary for new construction. Maryland Slag Company contributed $20,000 toward the construction cost, it being in its interest to do so since it had a contract with Bethlehem Steel Company to remove, process and market slag from the latter's blast furnaces at Sparrows Point and processed slag was used in making concrete. The Commissioner claimed that Arundel-Brooks Concrete Corporation had a cost and depreciation basis for the new plant of only $20,000 and the Board of Tax Appeals sustained him. The Circuit Court of Appeals for the Fourth Circuit reversed the Board and held that the corporation's cost and basis for depreciation of the plant was the $40,000 actually expended in the building thereof and not that sum less the $20,000 contributed by Maryland Slag Company toward the cost of construction, since " 'cost' * * * would remain the same regardless of the source of the funds from which payment was made".

The decision below is also in conflict with the earlier decision of the Circuit Court of Appeals for the Sixth Circuit in *Nashville Warehouse & Elevator Corp.* v. *Commissioner*, 105 F. (2d) 883, a case which the Court below thought distinguishable but which the Circuit Court of Appeals for the Fourth Circuit in *Arundel-Brooks Concrete Corp.* v. *Commissioner* said was persuasively analogous. In *Nashville Warehouse & Elevator Corp.* v. *Commissioner*, the taxpayer purchased elevator property for $40,000 payable in installments and paid all but $12,733.67 of the purchase price out of the proceeds of fire insurance collected upon the destruction of the property by fire. The Commissioner contended that the cost of the property to the taxpayer was $12,733.67, not $40,000. But the Court answered this by saying: "Obviously the full item should

be included in figuring the cost of the property. Whatever the source of the funds from which payment was made, the cost was $40,000."

An analogous but unsuccessful attempt to trace funds was once made by the Commissioner when he sought to require different treatment of unamortized bond discount on bonds retired with the proceeds of a refunding issue than on bonds retired with funds from other sources. But his attempt thus to make the source of the retirement funds of tax consequence was uniformly defeated; and the point must now be regarded as settled. *Great Western Power Co. of California* v. *Commissioner*, 297 U. S. 543.

Here too it is wholly immaterial from what source the petitioner obtained the money with which to construct its line extensions. The receipt of the funds and the construction of the extensions are severable transactions, each standing on its own feet for tax purposes, however related they may be economically. The cost to the petitioner of the extensions, and the basis thereof for depreciation, is the amount it expended on their construction; and, in basing its decision essentially upon tracing and giving importance to the source of the money used by petitioner, the decision below is unsound.

(3)

The perplexity and uncertainty that would result from attempting to trace the funds used in construction are well illustrated by the facts in the present case. Under the terms of some though not all of the contracts, *i.e.*, those typified by Exhibits I to IV inclusive (R. 16, 18-19, 21-34), the petitioner is obligated to make refunds over a five-year period after completion of construction. The amounts of refunds during this period cannot be prophesied; they may or may

not equal, though they cannot exceed, the total of the applicants' contributions. The amounts of the refunds are measured by future events, namely, the number of additional customers who subscribe for electric service over the line extensions or the gross revenue derived by the petitioner therefrom during the five-year period. If the funds used by the petitioner are to be traced in determining cost, the depreciation basis might vary from day to day, for refund periods expire at differing times and, until the period has run, every time an applicant uses power, and every time a new customer subscribes for service or is supplied from a line extension, an obligation to make a refund might accrue.

The Commissioner arbitrarily took annual balances of the payments made by applicants that were no longer refundable, and diminished petitioner's actual construction costs by the mean of those balances between the beginning and close of each of the years 1936 and 1937 (as well as by applicants' payments that were not refundable), allowing the remainder of the petitioner's costs irrespective of whether further refunds must be made. He was forced to adopt this arbitrary compromise position as an alternative to saying that line extensions constructed under refund contracts remain in a strange state of suspension taxwise during the first five years of their operation, with no depreciation allowable thereon during that period despite their exhaustible nature and their day-to-day use in the business.

The Court below recognized the illogical unsoundness of the Commissioner's position but reached a confusing and unsatisfactory conclusion. Holding that petitioner's cost of construction ought to be reduced by all applicants' contributions whether or not subject to refund on the ground that

they had "a direct relationship to cost", the Court mooted the question whether the portion of such contributions subsequently refunded should then be added back to cost as a capital expenditure or be treated as an ordinary business expense having no "reasonable relationship to the cost of a depreciable asset". The Court did not explain how payments of the same character could possibly fall within both of these two inconsistent categories, or how the mere refunding pursuant to agreement of a receipt not constituting income could possibly be a business expense. Likewise, it failed to comment on the obvious unfairness of denying depreciation on depreciable property during the first five years of its operation where the owner, refunding the applicants' entire contribution, bears the entire cost and actually suffers a current loss through wear and tear, or upon the practical impossibility of adjusting depreciation base from day to day as refunds are made or refund periods expire.

Moreover, the decision below would lead to this absurd result: assuming, for example, that the petitioner received $1000 from an applicant and constructed a line extension costing $1200 and that upon expiration of its useful life the petitioner replaced the extension at a cost of $1200 out of funds in its treasury, the decision below would require the original payment of $1000 still to be deducted, so that the petitioner would have a depreciation basis of only $200 although it actually expended $1200. The reason for this is that under the decision below, no matter what property is included in the petitioner's property account, unrefunded contributions theretofore made by applicants would have to be deducted in determining the depreciation basis even though the line extensions in respect of which the contri-

butions had been received had been replaced without requiring any further contributions from the applicants. Under the Uniform System of Accounts adopted by the Michigan Public Service Commission, the accounting procedure is as follows: When a payment is received from an applicant the petitioner's cash account is debited and a special account, No. 255 or No. 261, is credited. When a line extension is constructed the petitioner's cash account is credited and its property account is correspondingly debited. Current depreciation on the line extension is credited to depreciation reserve and debited to "Depreciation", which is an operating expense entering into profit and loss account. When the line extension is retired, the depreciation reserve is debited and the property account credited; no adjustment is made to accounts Nos. 255 or 261 by virtue of such retirement. Accordingly, if, in determining the depreciation basis for tax purposes at any given time, there is deducted from property account the unrefunded balance of the amounts credited to accounts Nos. 255 and 261, the result would be a depreciation basis having no relation to the line extensions then in existence that were constructed with the aid of applicants' contributions. In the course of time there would inevitably be a denial of depreciation basis for property on hand that was constructed by the petitioner with its own funds without outside aid.

The unsatisfactory results described above would all be avoided by following the legally sound and administratively necessary rule of disregarding the source of the funds expended on the construction of property in determining its cost.

II

EVEN IF THE CONSTRUCTION FUNDS COULD BE TRACED AND THEIR SOURCE WERE MATERIAL, PETITIONER'S BASIS FOR DEPRECIATION OF THE LINE EXTENSIONS UNDER THE STATUTE WOULD STILL BE THE AMOUNT EXPENDED ON THEIR CONSTRUCTION.

There is a basic dilemma here that the Commissioner cannot escape. Inevitably, the petitioner (a) acquired the line extensions for a consideration or (b) acquired them without a consideration. As we shall proceed to show, Congress has covered both contingencies in the statute, and it is immaterial to the petitioner which of the two premises is assumed to be the correct one. If the petitioner gave a consideration, then the amount of that consideration is the cost to it of the line extensions and its basis for depreciation. If it gave no consideration for the extensions on the theory that they were in effect contributed to it, then under the statute it takes over the line extensions at the transferors' basis, which was the cost thereof to them.

It is the petitioner's position, as hereinbefore pointed out, that it acquired the line extensions for a consideration consisting of the amount expended by it on their construction, and that the source of the construction funds even if traceable is immaterial in determining the cost of construction. If this is so, that cost is the depreciation basis. The applicants' contributions, though their status need not here be determined, stand on their own feet.

However, the Court below, insisting upon fixing the status of the contributions, ruled that the contributions were not gifts because supported by considerations, that

they were not contributions to capital or paid-in surplus because they were not made by shareholders and were for the specific purpose of constructing improvements but that, notwithstanding the presence of consideration, they constituted "receipts" which must be deducted under Section 113(b)(1)(A) of the statute in determining petitioner's cost. In so ruling, the Court was clearly in error.

(1)

The statute is of course controlling. Turning to the pertinent basis provisions of the 1936 Act set forth in the Appendix, we find that Section 114(a) provides that the basis upon which depreciation is to be allowed in respect of a property is the "adjusted basis" provided in Section 113(b) for the purpose of determining gain upon sale or other disposition of such property. Accordingly, if the line extensions have a basis to the petitioner for the purpose of determining gain on sale or exchange, they inevitably have the same basis for depreciation purposes as the Court below admitted; and, by denying petitioner any basis for depreciating them to the extent constructed with applicants' moneys, the Court below and the Commissioner place themselves in the paradoxical position of being forced to say that in the event of the sale of such extensions the entire proceeds would be income though the receipt of the money in the first instance, or indeed of the property itself if it had been directly contributed, was admittedly not income.[3]

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[3] In this connection, the status of railroad land grants may be noted. Such grants are not income (see pages 10, 11, 28 and 29 of this brief). It is well known that they have been commonly made not only to provide rights of way but to provide railroad capital through sale of donated lands adjacent thereto. To deny any basis for lands so sold would largely frustrate the purpose of the grants.

Since Section 114(a) directs us to Section 113(b) for the depreciation basis, we turn to this latter provision. It deals with "adjusted basis"; and, logically enough, it refers back to subdivision (a) of Section 113 for a definition of "basis (unadjusted)", for subdivision (b) merely supplies the adjustments to be made to the unadjusted basis, which must be first determined.

Subdivision (a) of Section 113 is the vital provision. It starts with the simple statement that the basis (unadjusted) of property shall be the cost of such property and then proceeds with a long list of carefully drawn exceptions, of which it is now important only to note that if property is acquired after 1920 by gift, or as paid-in surplus, or as a contribution to capital, then under exceptions (2) and (8)(B) the transferor's basis is to be used.

The statute recognizes the fundamental principle that depreciation sustained through use of exhaustible property in a business is an inevitable burden of doing business, and that profits cannot be determined until depreciation is taken into account.[4] It undertakes to cover in detail the whole field of allowances for depreciation and the depreciation basis, however the property may have been acquired. Congress was concerned with the fact that it is

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[4] The comment of the Court below, that allowance of depreciation deductions, like all deductions, is a matter of legislative grace, should not be passed unnoticed. Accrued depreciation, differing from other deductions, must be deducted in determining cost of property even though the statute is silent, because of its essential nature as a return of capital. *United States* v. *Ludey*, 274 U. S. 295. It is by no means clear that depreciation, similar to cost of goods sold (*Goodrich* v. *Edwards*, 255 U. S. 527; *Burnet* v. *Logan*, 283 U. S. 404), need not as a matter of constitutional law be taken into account in arriving at gross income. See Magill, Taxable Income, page 329.

the property itself that depreciates; and it provided for a continuity of the depreciation basis and gave a new basis only when an owner, paying a consideration, ought not to be tied to someone else's cost.

(2)

The Court below stated that the contributions "were supported by considerations", since the petitioner "obligated itself to build the facilities and the contributors expected to obtain full remuneration by use of the electric energy produced by the petitioner". Yet having found consideration the Court failed to recognize the value thereof in any way. At this point it may be well to quote from the decision of the Board of Tax Appeals in *Robinson* v. *Commissioner*, 35 B. T. A. 1080, affirmed 97 F. (2d) 552 (C. C. A. 9th):

> "The respondent argues that the transfer * * * was not a gift to petitioner, but was for a valuable consideration. At the same time he contends that they cost him nothing. We do not think these positions are consistent."

If the contributions and the subsequent construction of the line extensions out of petitioner's general working funds are not severable transactions standing on their own feet, the transactions obviously cannot reasonably be interpreted any differently than if the facilities had themselves been contributed in lieu of the equivalent in cash, as the petitioner's rules permitted. To say that the consideration for the contributions was the agreement to construct is to disregard substance; if it means anything at all it is that the contributions were bought with an obligation, fully performed, of at least equal worth. And of course the contributions cannot consistently be treated as receipts

serving to reduce basis under Section 113(b)(1)(A) if they were acquired for a consideration.

Conceivably, however, the Court could have found consideration. Disregarding its agreement to construct them, what did the petitioner give and the applicants for service get? In each case, the fundamental purpose of the deal was to bring about a situation whereby the petitioner would be legally obligated: (a) to sell electric energy at the usual regulated rates to the applicant and others who could be served from the line extension, and to serve them not only for the moment but continuously so long as they desired service or until the Michigan Public Service Commission should authorize abandonment of the line; and (b) to maintain the line extension and at the expiration of its useful life replace it, and again and again to repeat this process, all at the petitioner's own expense and regardless of profit therefrom, in order that the petitioner might live up to its continuous obligation to serve. These were the petitioner's resulting obligations: they would not have existed had not the particular line extension requested been constructed; they came into existence by virtue of the construction pursuant to the contract; and they were the very reason why the applicant entered into the contract and made the payment. Under well-settled principles of law, the petitioner's obligations thus arising might be considered implied terms of the contract. *Northern Pacific Railway Co.* v. *Wall*, 241 U. S. 87; *Guilford Lumber Manufacturing Co.* v. *Holladay*, 178 N. C. 417, 100 S. E. 597; *Wood* v. *Duff-Gordon*, 222 N. Y. 88, 118 N. E. 214; and 5 Williston, Contracts, § 1293, page 3683.

This being true, the case at bar is strikingly similar to *Robinson* v. *Commissioner, supra.* There the owner of a

public utility entered into contracts, with the approval of the Railroad Commission of California, whereby he received from the subdividers of certain land title to water mains, pipes and other connections, to be installed by the subdividers or at their expense, in consideration for which he agreed to maintain the property so received and to furnish at regular rates an adequate supply of water to consumers in the subdivision. The basic question in the case was the cost of the property to the public utility owner; and both the Board and the Court held that the value of his agreements, constituting his cost of the property, was the value of that property since it was given to him in return for his agreements in a transaction entered into between parties dealing at arm's length.

A similar finding could be made here. The petitioner's obligations were thought by the applicants to be worth what they gave. The line extensions were thought by the petitioner to be worth the obligations it incurred; the petitioner would not have undertaken these obligations without the payment. The Michigan Public Service Commission approved the arrangement. Since the parties were dealing at arm's length and the transactions were approved by the Commission, it could reasonably be presumed that there was a fair exchange, and that the value of the consideration given by each side corresponded. In this view, the consideration given by the petitioner for the line extensions, and accordingly their cost, would be equal to what it got in exchange, namely, the value of the line extensions, which was their cost of construction.[5]

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[5] The decisions in the *Robinson* case, which were ignored in the opinions below, were doubtless influenced by the fact that the contributions to the individual taxpayer were induced by busi-

(3)

The Commissioner attempted below to distinguish the *Robinson* case chiefly on the ground that under the contracts here in question the petitioner incurred no obligation in return for what it received, its only obligations being those arising by operation of law or expressed in subsequently executed contracts for the sale of electrical energy. If this view is correct in the light of this Court's recent decision in *Helvering* v. *American Dental Co.* decided March 1, 1943, it inevitably follows that there being no consideration the contributions occupy the status of gifts or, more properly, of contributions to capital required in order to equalize the burden among the new and old consumers. The situation would then be viewed as if the petitioner and the Michigan Public Service Commission had said to each applicant: "consumers generally should not be made to bear the expense of an unprofitable extension simply for the convenience of serving you. If you want to be in a position to demand service from the petitioner you must first make a gift to it or a contribution to its capital sufficient to cover the excess burden of undertaking to serve you."

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ness motives, and possibly also by the fact that a transferee corporation assumed the taxpayer's obligations (presumably at the taxpayer's basis) resulting in an earlier recovery of basis by him. The facts in the *Robinson* case were somewhat similiar to those in *Southern Power & Manufacturing Co.* v. *Commissioner*, 82 F. (2) 104 (C.C.A. 5th), cited below; but there the questions of gift or consideration were not even discussed, the issue being restricted to whether on the facts a tax-free reorganization, involving a carry-forward of basis, had occurred when utility property was transferred by promoters to a corporation in 1923. The case of *Kell* v. *Commissioner*, 88 F. (2d) 453 (C. C. A. 5th), also cited below, involved quite a different question; the case simply stands for the obvious proposition that outside donations in money and property received by a railroad corporation do not constitute part of the individual promoter's costs.

But this view leads us to the same result, for under Section 113(a)(2) and (8)(B) of the statute and Article 113(a)(8)-1 of the regulations, quoted in the Appendix, the transferor's basis follows property that is received after 1920 as a gift or as a contribution to capital.

In ruling that the contributions petitioner received were not gifts, the Court below was influenced by the existence of business motives. The contributors "expected to obtain full remuneration by use of the electric energy produced". Since the decision below, this Court in *Helvering* v. *American Dental Co., supra,* has held business motives not inconsistent with a gift. In that case the taxpayer's landlord and certain commercial creditors cancelled certain past due obligations. The Commissioner urged that the cancellations involved realization of income and not gifts since the creditors acted for purely business reasons in anticipation of future business and not for altruistic reasons or out of pure generosity; and the Board of Tax Appeals sustained him. The Circuit Court of Appeals for the Seventh Circuit, in reversing the Board and holding the cancellations gifts, said:

> "Suppose the creditors did act for purely business reasons. As long as there was no consideration for the cancellation, the intent to give necessarily followed. Evidently the Board confused intent with motive. There is no evidence that the creditors did that which they did not intend to do. The creditors' motives are immaterial."

This Court affirmed, saying:

> "The fact that the motives leading to the cancellations were those of business or even selfish, if it be true, is not significant. The forgiveness was gratuitous, a release of something to the debtor for nothing,

and sufficient to make the cancellation here gifts within the statute."

This reasoning applies with even greater force to contributions to capital. Capital contributions are commonly made in commercial transactions; and it is upon the provisions of the statute and regulations in this regard—Section 113(a)(8)(B) and Article 113(a)(8)-1—that petitioner more heavily relies. But the Court below thought that the contributions here did not constitute contributions to capital because being conditioned upon a specified use they did not become irrevocably devoted to the satisfaction of all petitioner's obligations and because they were not made by shareholders. The Court erred on both counts. Capital contributions, as in the case of gifts, may properly be made for specific purposes; the conditions imposed by the contributors were in no sense inconsistent with the vesting of full title and control in the petitioner. *Edson* v. *Lucas,* 40 F. (2d) 398, 405 (C. C. A. 8th). And clearly, as the Commissioner's regulations expressly recognize, capital contributions may properly be made by non-stockholders.

Article 113(a)(8)-1 of Regulations 94, promulgated under the Revenue Act of 1936, expressly provides that property may be received "from a shareholder as paid-in surplus, or from any person as a contribution to capital". This quoted language has been contained in the Treasury Regulations through successive reenactments of the statute continuously since 1934 and is still outstanding. Article 113(a)(8)-1 of Regulations 86, 94 and 101; Section 19.113(a)(8)-1 of Regulations 103. Identical language is contained in the recently issued Excess Profits Tax Regulations 109, Section 30.718-1, and in Bulletin "F" (Revised January, 1942) of the Internal Revenue Bureau. Accord-

ingly, this unambiguous provision of the regulations now has the force of law. *Helvering* v. *Wilshire Oil Co., Inc.*, 308 U. S. 90, and *Helvering* v. *R. J. Reynolds Tobacco Co.*, 306 U. S. 110. Yet the Circuit Court of Appeals ignored it and ruled that the payments made by petitioner's prospective customers could not constitute contributions to capital since they were not made by shareholders. (*Cf.* Alexander Tax News Letters, December 11 and 18, 1942.)

The above quoted regulation doubtless stems from just such cases as *Edwards* v. *Cuba Railroad Co.*, 268 U. S. 628. That case involved the taxability as income of money subsidies granted by the Cuban Government to a railroad company to promote construction of a railroad in Cuba and coincidentally to obtain reduced rates and other privileges. The subsidies were fixed and paid proportionately to mileage actually constructed and were used by the company for capital expenditures but were not used to reduce the actual cost of construction as carried on the books. In addition to the money subsidies the Cuban Government also contributed certain lands and other physical property in aid of completion of the railroad. The Treasury sought to tax the money but not the property. This Court, stating that the subsidies of neither kind were received as mere gratuities, held that they were not income and indicated that they were capital contributions, saying:

> "The subsidy payments were proportionate to mileage completed; and this indicates a purpose to reimburse plaintiff for capital expenditures. All—the physical properties and the money subsidies—were given for the same purposes. It cannot reasonably be held that one was contribution to capital assets, and that the other was profit, gain or income."

There, as here, the subsidies were received from non-stockholders and for the specific purpose of constructing property. Yet this Court considered them capital contributions.

There, this Court thought that contributions in money and physical properties for similar specific purposes should be treated alike. Here, if the line extensions themselves had been contributed to petitioner in lieu of cash as petitioner's rules permitted, they obviously would have constituted capital contributions, not receipts serving to reduce the cost of any of petitioner's assets under Section 113(b)(1)(A). Yet the Court below would apparently distinguish between the treatment of cash and property contributions for the same purposes, since it has here applied Section 113(b)(1)(A) to the receipt of the cash.

(4)

Section 113(b)(1)(A) is not determinative of the issue here. To hold that it is, as did the Court below, is simply to beg the question, for the legal status of the contributions petitioner received would still be open for decision.

Section 113(b)(1)(A) merely contains the expected requirement that, in arriving at the "adjusted basis" of property, adjustment must be made to the "basis (unadjusted)" for items "properly chargeable to capital account". It relates only to subsequent capital items, for the very scheme of the statute calls first for a determination of "basis (unadjusted)", before Section 113(b)(1)(A) calling for adjustments thereto can come into play. In other words, the provision is an adjective not a subjective one, merely calling for subsequent adjustments if any should be made and not specifying what adjustments if any ought to be made.

Moreover, Section 113(b)(1)(A) contemplates adjustments both up and down. While, from a strictly accounting standpoint, to charge capital account commonly means to make capital account responsible, *i.e.*, to debit capital account, not to relieve it of responsibility by means of a credit (Webster's New International Dictionary, Standard Edition), the phrase "properly chargeable to capital account" as used in the statute was doubtless intended from its context to mean "properly attributable to capital account" and to encompass both debits and credits to capital account. Accordingly a subsequent capital "receipt" may increase or decrease "basis (unadjusted)", depending on its real nature. A receipt resulting from reduction of the purchase price of property, or from return against refund of unused construction material, or from reduction on final adjustment of the price paid a contractor for construction, or the like, calls for a decrease in capital account under Section 113(b)(1)(A). On the other hand, a receipt constituting a contribution to capital or a gift has exactly the opposite effect.

Thus it is entirely inaccurate to assume, as did the Court below, that "all receipts having some reasonable relationship to the asset, must be deducted from the cost". That the contributions here involved "had a direct relationship to the cost" of petitioner's facilities does indicate agreement that they are capital in nature, but the issue still remains whether or not they were gifts or capital contributions serving to increase, not decrease, capital account.

If an applicant builds a line extension and contributes it to petitioner in lieu of cash, can the contribution serve to reduce the basis of any of petitioner's property by adjustment of the unadjusted basis under Section 113(b)

(1)(A)? The question answers itself. The basis for petitioner's other property would not be affected. A single property contribution cannot create a basis and an adjustment of it as well. On the contrary, the line extension, if not deemed acquired for a consideration the value of which would establish its cost to the petitioner, would be a gift or a contribution to capital entitling petitioner under Section 113(a)(2) or (8)(B) to take over the extension at the contributor's cost.

This being so, if an applicant contributes funds exactly equivalent to the cost of an extension for the specific purpose of obtaining its construction, can the result be any different? Can it then be said that petitioner had a cost (*i.e.*, a "basis (unadjusted)") for the extension under Section 113(a) equal to the amount expended on its construction but that as a result of the antecedent contribution such cost is brought down to zero by subsequent adjustment under Section 113(b)(1)(A), whether or not the contribution is deemed received for a consideration?

If, as seems clear, the result under the scheme of the statute must be the same in both cases, can a distinction be drawn in the treatment of a contribution where under circumstances otherwise identical only half the cost of construction is contributed? Surely the answer must be no; and this demonstrates the fundamental error into which the Court below fell in its application of Section 113(b)(1)(A) to the contributions in the case at bar. This is true wholly apart from the Court's inconsistency in applying that basis adjustment provision to a receipt for which it found consideration had been given.

To summarize, Section 113(b)(1)(A) can have no different effect upon the basis of the line extensions here in

question than if they had been built by the prospective customers in the first instance and then turned over to the petitioner in lieu of cash, as the petitioner's rules expressly permitted. The correct view is that the cash contributions increased capital account, and when expended for capital assets served to increase the basis thereof, to exactly the same extent as if there had been a contribution of the property itself. In either case the basis for depreciation is the same under the scheme of the statute. For the contribution in either case is received under circumstances characterized by this Court in *Edwards* v. *Cuba Railroad Co.*, *supra*, as constituting a contribution to capital, and as such it comes squarely within Section 113(a)(8)(B) of the statute and Article 113(a)(8)-1 of the regulations.

Accordingly, Section 113(b)(1)(A) furnishes no aid in the solution of the issue here.

(5)

We thus come back to the inescapable fact that the line extensions were acquired by petitioner either for a consideration or without a consideration. If acquired for a consideration, the amount or value of that consideration is petitioner's cost and basis for depreciation under the general rule in Section 113(a) of the statute. If acquired without a consideration on the theory that they were in effect contributed by the prospective customers, then the petitioner took over the latter's basis under Section 113(a)(2) or (8)(B). Under either of these theories—alternatives covering the whole field—the result is the same: the petitioner's depreciation basis for the line extensions is what it cost to construct them.

This result is entirely sound, for if the petitioner is not allowed to deduct depreciation on this basis, then no

one will be entitled to the depreciation which the statute generally contemplates should be allowed to someone.

The Commissioner suggested below that a customer making a cash contribution may have a depreciable interest in the particular line extension, and argued therefrom that the petitioner ought not to be permitted to depreciate at the full cost since two taxpayers might then be depreciating the same thing. But so far as the petitioner is aware the Commissioner has not offered to allow customers such depreciation, and his regulations do not provide for it. His suggestion is in fact wholly without merit. It is clear that if a customer builds and owns a line extension in connection with his business, he, and he alone, is entitled to depreciation on it, no matter whence he derived the funds. The utility could not take depreciation, for it does not own the property and suffers no depreciation on it. Thus, in respect of poles furnished and owned by applicants in accordance with Exhibit V (R. 35-37), the petitioner is entitled to no depreciation; such poles are not included in the petitioner's property account or in the amount specified in paragraph (11) of the stipulation of facts. On the other hand, where as here the utility owns, controls and operates the line extension, it is entitled to depreciation on it and the customer can take no depreciation even though he contributed it or made a cash contribution to procure its construction. In such case, the customer has no legal or equitable title to or interest in or control over any particular extension. His only right is the legal right in common with all customers to take advantage of the public utility law which requires the recipient as a public utility to serve its customers and to continue to serve them, without limit as to time, once it undertakes to serve their territory, unless

and until the Public Service Commission permits otherwise. Such a right, representing no interest in or control over any particular line extension, continuing indefinitely through successive renewals and replacements of the original extension, and common to all customers, could not possibly be made the basis for depreciation. Under the statute the right to depreciation and the obligation to report gain on sale of an extension go hand in hand. Here the burden of reporting such profit would clearly rest upon the petitioner alone; and correspondingly it is entitled to the entire depreciation.

The Commissioner also countered below with cases, mostly involving leased property, which involved special situations wholly distinguishable and which involved no element of contribution to capital or gift. Of course a lessor, who suffers no depreciation because his lessee has covenanted to make it good, is entitled to no depreciation deduction. Of course a lessee is entitled to no depreciation deduction in respect of leased property which he neither constructs nor owns and for the use of which he pays a deductible rental. Of course a tenant constructing property on leased premises has a right to depreciate or amortize his cost of construction over the useful life of the structure or the term of the lease, whichever is shorter. Treasury Regulations 103, Section 19.23(a)-10. And of course a tenant who simply constructs property for the landlord on the leased premises at the landlord's expense, as in the second issue in *Nashville Warehouse & Elevator Corp.* v. *Commissioner, supra*, from which the Commissioner sought below to derive comfort, comes within the former and not the latter category. But all this has no bearing upon the general policy of the statute or upon the case at bar. Here,

contrary to the lease cases, the petitioner owns and operates the property and suffers depreciation on it; and the only question is the basis for depreciation under the statute.

Petitioner's position, we repeat, is in accordance with the terms and the spirit of the statute. If a taxpayer owns a plant, the statute authorizes deduction of depreciation on it whether it was acquired for a consideration or without a consideration. If the taxpayer built it or otherwise acquired it for a consideration, the depreciation basis is the amount or value of the consideration given for it by the taxpayer, which would be its cost; and this would be true irrespective of whether the money utilized for that purpose was derived from capital, earnings, borrowings, gifts, inheritance or any other source. If the taxpayer gave no consideration and accordingly received the plant as a gift or inheritance or as a contribution to capital or paid-in surplus, the depreciation basis would continue to be the same as in the hands of the transferor. The operation of the plant of necessity consumes it over its useful life, the owner thereby suffers a loss and hence depreciation is allowed.

III

ALLOWANCE OF THE DEPRECIATION HERE CLAIMED WOULD PRODUCE A WHOLLY FAIR AND REASONABLE RESULT.

Whether or not the depreciation here claimed by the petitioner ought in fairness to be allowed is basically irrelevant. The wisdom of the deduction is for Congress to decide; and if the statute and regulations provide for the depreciation it must be allowed whether or not the Courts

would have chosen otherwise. Cf. *Helvering* v. *Credit Alliance Corp.*, 316 U. S. 107. Cf. also *Helvering* v. *Sabine Transportation Co., Inc.*, decided March 1, 1943, in which this Court sustained as authorized by statute the allowance of a dividends paid credit both at the time of issuance of bonds to the issuer's stockholders and at the time of their payment.

However, since the Board's judgment was clouded by failure to understand the effect of the allowance of the claimed depreciation and by an erroneous assumption that a "double benefit" would result therefrom, and since the judgment of the Circuit Court of Appeals may have been similarly clouded, it seems appropriate in conclusion to address ourselves to that point. This calls for a review of the background out of which this case arose, a background which may have been overlooked.

As a public utility, petitioner is obliged to render service to all those who can be served from its distribution system, but not beyond; and its rates and practices generally are subject to the regulatory supervision of the Michigan Public Service Commission.

Requests for electric service by farmers and other prospective consumers located at remote points beyond the territory served by the petitioner's distribution system are from time to time received. The future energy requirements of such applicants for service are uncertain and may be limited. At the very least, the cost of constructing the necessary line extensions would make the cost of serving them greater than the cost of serving the consuming public generally.

What then should be done? The problem is of fundamental concern to the consuming public. The petitioner as

a public utility is always entitled to a reasonable profit; its profits cannot be excessive but it is entitled to charge rates that will not result in so low an overall profit as to be confiscatory. If customers in remote areas fail to pay their way, other customers must bear the burden. Each member of the consuming public has a vital interest in paying only a reasonable amount for the service rendered to him. He does not want, and in fairness should not be asked, to pay rates that are excessive in relation to the cost of the service rendered to him, simply to enable a few new customers in outlying districts to obtain service.

The best and most practical method of handling the situation in the interests of all concerned is the one sanctioned by the Michigan Public Service Commission and adopted by the petitioner here. The petitioner puts itself in a position to render service to such applicants by acquiring, maintaining and operating the necessary line extensions as part of its system. A uniform schedule of rates is adopted under which no distinction is drawn between the rates charged those served from the line extensions and the rates charged those served from the distribution system as a whole. An unfair burden on the balance of the consuming public is avoided by requiring applicants at their election either to build and contribute the extensions or to make cash contributions in aid of construction before the petitioner undertakes for their benefit to maintain and operate extensions that cannot earn their own way. And, in appropriate cases where the extent to which the extensions can earn their own way cannot be foreseen, the applicants are protected against overpayment by returning to them all or such part of their contributions as would appear at the expiration of a reasonable period to have been unnecessary.

This arrangement is fundamentally a fair one all around. The burden is fairly apportioned among consumers in accordance with the relative cost of serving them. The applicants, by contributing the extensions or cash, become entitled to obtain service at the regular uniform rates, a service which they would not otherwise be in a position to demand. The petitioner, being justified by the applicants' contributions includes the line extensions as a part of its regular system and becomes subject to all the responsibilities thereby entailed. It must continue to render service over the line extensions so long as any consumer demands service therefrom or until the Public Service Commission authorizes otherwise. It must maintain and repair the extensions in order that it may continue to render such service. It is liable for damage and injuries resulting from their operation. And at the expiration of their useful lives it must replace them in order to continue rendering service, without any opportunity at that time to obtain any further special contributions regardless of the cost of rendering the service.

The contributions made by applicants being designed to equalize the burden among consumers, the petitioner is not permitted to increase its overall earnings by virtue of the receipt thereof. They must either be deducted from assets in determining the rate base or the same result must be accomplished by taking the contributions currently into earnings for rate making purposes. *Re The Detroit Edison Co.*, 16 P. U. R. (N. S.) 59 (Michigan, 1936); *Re Harmony Electric Co.*, P. U. R. 1933A 306 (Michigan, 1932); *Re Northern Power Co.*, P. U. R. 1933C 128, 131 (Michigan, 1932). It is for this purpose that the segre-

gated accounts, Nos. 255 and 261 (described at R. 17-18), are utilized.

Although the petitioner's overall return must not include a return on applicants' contributions, the petitioner is required to depreciate the line extensions as in the case of its other property which has a limited useful life in order to build up a replacement fund that is necessary if a repetition of the same problem is to be avoided when the extensions must be replaced. Under the requirements of the Uniform System of Accounts adopted by the Michigan Public Service Commission, the depreciation on line extensions is handled through ordinary accounts in the regular way and is deducted in arriving at net earnings. It is credited to the depreciation reserve, and a balancing debit is made to Account 502, entitled "Depreciation", which is classified under operating revenue deductions and which is an operating expense. The entries are made in the same manner as though there had been no applicants' contributions.

This in general is the procedure. It is one that has been developed under the supervision of the Michigan Public Service Commission primarily in the interest of the consuming public, not the petitioner. Obviously the Commission would not countenance any arrangement that would give the petitioner something for nothing.

The Board thought that a "double benefit" would result if the petitioner were allowed both to receive the contributions without tax and to deduct depreciation on line extensions constructed with the aid thereof. But where in this is there any undue advantage or "double benefit"? As we have seen, the petitioner seeks the contributions and the Michigan Public Service Commission permits them to be received because the consuming public gen-

erally, to whom the burden would be passed on, should not bear the expense of unprofitable extensions for the convenience of one or a few persons. As a matter of fact, to the petitioner these contributions really result in no "benefit" at all, since they entail the commensurate responsibilities described above. Contributions of this character which are designed simply to apportion the consumer burden fairly, which may remain segregated long after the disappearance and replacement of the original line extensions, and upon which even after the original line extensions have gone the petitioner is not permitted to earn, have rightly been uniformly held not to constitute taxable income. On the other hand, the petitioner is under obligation to replace the extensions in order to continue to render service; hence if it were not allowed to build up a reserve through current depreciation it would be faced at the time of retirement with the very problem which the entire arrangement was intended to avoid. There is as much reason for providing for the rebuilding of the extensions as there is for the building of them in the first place, for the very basis of the original arrangement is that petitioner would be entitled to a continuance of the grant so long as its service obligations continued, without in effect being required to "buy" the extensions in order to carry out the obligations it undertook. The Michigan Commission, in common with other State Commissions,[6] recognizes this by denying the right to earn on the

[6] *Cf. Department of Public Service* v. *Grays Harbor Railway & Light Co.*, 12 P.U.R. (N.S.) 178, 197 (Washington, 1936); *Department of Public Service* v. *Pacific Power & Light Co.*, 13 P.U.R. (N.S.) 187, 204 (Washington, 1936); *Re Union & Jordan Irrigation Co.*, 30 P.U.R. (N.S.) 281, 287 (Utah, 1939); *Re Otter Tail Power Co.*, 33 P.U.R. (N.S.) 301 (North Dakota, 1940).

applicants' contributions but allowing deduction from current earnings of current depreciation so as to build up a reserve for rebuilding. While the governing revenue act does not make this a ground for allowance of depreciation for tax purposes, nevertheless the statute does by its terms authorize depreciation here. This being so, there is no occasion for straining to deny what the statute allows since allowance of depreciation for tax purposes, consistent with standard practice, would merely result in allowing the petitioner to accumulate a fund without tax thereon that is necessary to rebuild extensions which in the first instance were received without tax or were constructed with the aid of funds which it was permitted to receive without tax. If the contracts under which the extensions were built had required the applicants to pay the cost of rebuilding when their useful life was over and to put up security therefor, the petitioner would not need or be entitled to depreciation as it would get funds to rebuild, free of tax, just as it obtained the applicants' original contributions. But such contracts are impractical, and the same result can be accomplished so far as the petitioner is concerned only by the allowance of the depreciation it here claims.

Thus, the petitioner's position involves no doubling of advantages from the same thing. The only thing "double" about it is that the problem that arises when the line extensions are first built comes up again in connection with their replacement. A treatment concededly warranted when the problem first arises is equally as warranted when it recurs. The accumulation of funds without tax to replace the line extensions is as justifiable and proper as the receipt of applicants' contributions without tax concededly is in the first instance.

If when a line extension requires replacement the applicant were to make a new contribution to the petitioner, that contribution would be just as free from tax when received as the contribution made at the time of original construction—it is not a "double benefit" to be prohibited. The petitioner's position here is exactly the same, though the funds to rebuild come from depreciation instead of from the applicant. There is no "double benefit" in getting the funds to replace whether they come from either source.

Indeed, the petitioner gets no "benefit" therefrom at all. To call it such when there are commensurate burdens and responsibilities is a misnomer. But, waiving the misnomer, it is not in any sense a double benefit but at most a second benefit; replacement of the line extension simply requires a repetition of the benefit given at the time of the original installation.

Actually, however, it is not even a second benefit. The original grant is simply continued. For the original arrangement basically contemplated that the petitioner would be entitled to a continuance of the grant so long as its service obligations continued, without being required at any stage in effect to "buy" the line extensions in order to carry out the service obligations it originally incurred.

The petitioner's position on this point should not be misunderstood: it does not say that the foregoing considerations would of themselves give it the right to depreciation for tax purposes; but it does say that these considerations establish that there is no unfair advantage or "double benefit" that should deprive it of the allowance for depreciation given by the statute.

IV

CONCLUSION

Allowance of the depreciation deductions here claimed by the petitioner is plainly within the statute, is eminently fair, and should be approved. Accordingly the decision of the Court below should be reversed.

Respectfully submitted,

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APPENDIX

Pertinent Provisions of the Revenue Act of 1936, Ch. 690, 49 Stat. 1648.

"SEC. 23. DEDUCTIONS FROM GROSS INCOME.

"In computing net income there shall be allowed as deductions:

* * *

"(1) *Depreciation.*—A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence. * * *

* * *

"(*n*) *Basis for depreciation and depletion.*—The basis upon which depletion, exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be as provided in section 114."

"SEC. 114. BASIS FOR DEPRECIATION AND DEPLETION.

"(*a*) *Basis for depreciation.*—The basis upon which exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be the adjusted basis provided in section 113(b) for the purpose of determining the gain upon the sale or other disposition of such property."

"SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

"(*a*) *Basis (unadjusted) of property.*—The basis of property shall be the cost of such property; except that—

* * *

"(2) *Gifts after December 31, 1920.*—If the property was acquired by gift after December 31, 1920, the basis shall be the same as it would be in the hands of the donor or the last preceding owner by whom it was not acquired by gift, except that for the purpose of determining loss the basis shall be the basis so determined or the fair market value of the property at the time of the gift, whichever is lower.

* * *

"(4) *Gift or transfer in trust before January 1, 1921.*—If the property was acquired by gift or transfer in trust on or before December 31, 1920, the basis shall be the fair market value of such property at the time of such acquisition.

* * *

"(8) *Property acquired by issuance of stock or as paid-in surplus.*—If the property was acquired after December 31, 1920, by a corporation—

* * *

(B) as paid-in surplus or as a contribution to capital,

then the basis shall be the same as it would be in the hands of the transferor, * * *

* * *

"(b) *Adjusted basis.*—The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis determined under subsection (a), adjusted as hereinafter provided.

"(1) *General rule.*—Proper adjustment in respect of the property shall in all cases be made—

"(A) for expenditures, receipts, losses, or other items, properly chargeable to capital account, including taxes and other carrying charges on unimproved and unproductive real property, but no such adjustment shall be made for taxes or other carrying charges for which deductions have been taken by the taxpayer in determining net income for the taxable year or prior taxable years;"

Treasury Regulations 94, promulgated under the Revenue Act of 1936, provide with respect to Section 113(a)(8)(B):

"Art. 113(a)(8)-1. Property acquired by a corporation after December 31, 1920.— * *

"In respect of property acquired by a corporation after December 31, 1920, from a shareholder as paid-in surplus, or from any person as a contribution to capital, the basis of the property in the hands of the corporation is the basis which the property would have had in the hands of the transferor if the transfer had not been made. * * *"

FILE COPY

IN THE

Supreme Court of the United States

OCTOBER TERM, 1942

No. 675

THE DETROIT EDISON COMPANY,
Petitioner,

against

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

REPLY BRIEF FOR PETITIONER

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REPLY BRIEF FOR PETITIONER

Respondent in his brief predicates his case basically upon the argument that Section 23(1) of the statute, which provides for depreciation allowances, presupposes (a) "that the claimant actually *suffer* depreciation—that is, that the burden of the economic loss due to the exhaustion, wear and tear of the property actually be borne by it" (p. 9) and (b) that no such loss is suffered by a claimant unless it "has made a capital investment in the property" (p. 12). Because in the present case "the very purpose of the arrangement made by taxpayer with its applicants is to relieve taxpayer of the burden of making an investment of its own capital" (p. 14), respondent argues that petitioner has made no capital investment in the line extensions and that it therefore suffers no present loss and is entitled to no depreciation deduction. He cites authority for the proposition that a taxpayer must have an economic or beneficial interest in

order to be entitled to depreciation; but that proposition does not help him here. He is forced to go further and contend that the economic or beneficial interest must have been acquired by the taxpayer through an investment out of its own pocketbook; but as to that his position is unsound, as the statute is to the contrary.

(1)

Either the receipt of a contribution and the subsequent construction of a line extension must be treated as severable transactions, each standing on its own feet for tax purposes, or the two must be telescoped and the situation regarded as in substance the same as if the line extension had been constructed in the first instance by the applicant and had then been contributed to petitioner in lieu of cash.

If the former view is adopted, then petitioner, as urged under Point I of its main brief, has a cost of the line extension and therefore a capital investment therein equal to the amount expended on its construction. It built the extension, using its own general funds for that purpose; and where it obtained the funds, whether from earnings, loans, capital contributions, gifts or otherwise, is wholly immaterial. The contribution stands on its own feet. Under this view, respondent's entire argument falls.

If, on the other hand, the contribution and construction are so interrelated that they must be put together as one transaction, the transaction being in substance the same as if the extension itself had been contributed, then, though the petitioner admittedly has personally made no capital investment therein, under the statute it steps into the contributor's shoes and is given the right to use as its own

the latter's capital investment. In this view, Section 113(b)(1)(A) could not possibly be applied to reduce the "basis (unadjusted)" of the extension by virtue of the receipt of cash. There is no preexisting basis to adjust, since the transaction simply amounts to a contribution of the extension itself and the passage of cash is disregarded as a mechanical detail. And for like reasons Section 113(a)(8)(B), relating to basis of property received as a contribution to capital, could not possibly be considered inapplicable either because "the customers did not transfer the facilities themselves to the taxpayer" (p. 25) or because "if the company had failed to construct the facilities in question, the consumers would doubtless have been entitled to a refund of the entire amount of the contributions" (p. 26).

Respondent's argument in this regard is inconsistent and begs the question. In arguing that petitioner made no capital investment, he emphasizes the importance of substance over form, ignoring Point I of petitioner's brief, contending that the fundamental purpose of the arrangement was to avoid a capital investment, and saying that whether the contributions were received before construction or afterwards, as in *Edwards* v. *Cuba Railroad Co.*, 268 U. S. 628, cannot alter the substance of the transaction. Yet he refuses to accept the logical consequences of his own argument—that the situation is in substance the same as if the line extensions had been built by the prospective customers and had then been contributed to petitioner in lieu of cash. Inconsistently, he urges the applicability of Section 113(b)(1)(A) to the receipt of the cash, and the inapplicability of Section 113(a)(8)(B) because cash and not property was contributed and because the contributions

were tied up with the construction and would have to be paid back if construction had not ensued.

It is immaterial to the petitioner which view is adopted. For the status of the cash contributions, though unimportant if tested separately, must be precisely the same as if the property itself had been contributed for the identical purpose; and under either view, we come to the same result: petitioner's basis for depreciation under the statute is the amount expended on construction.

Petitioner's rule No. 5, on file with the Michigan Public Service Commission and printed on the reverse side of the regular line extension agreements, Exhibits I and II (R. 21, 25), expressly provides for two alternative procedures to accomplish the same result. It provides that "the applicant for service may build the line extension for the same at his cost, according to the Company's specifications; or may employ the Company to build the same at his cost, payable in advance; and in either such case the Company will refund to the applicant", etc. Instruction No. 3, printed on the face of these agreements, calls for their use under either alternative, with simply the addition of a proper rider if the contributor elects to build. The real substance of the transaction is the same whichever alternative is adopted, and surely the tax consequences must be the same regardless of the mechanical procedure used.

The decisions and rulings dealing with the non-taxability as income of such contributions and subsidies reach the same result whether the contributor first built the property and then contributed it (see *e.g. Liberty Light & Power Co.*, 4 B. T. A. 155; *Rio Electric Co.*, 9 B. T. A. 1332) or whether he contributed cash for construction of the property and the recipient built it (see *e.g. Wisconsin Hydro-Electric Co.*, 10 B. T. A. 933; *El Paso Electric Railway Co.*,

10 B. T. A. 79; *Tampa Electric Co.*, 12 B. T. A. 1002); and the respondent has acquiesced. See *G. C. M. 1581*, VI-1 C. B. 197; *G. C. M. 16952*, 1937-1 C. B. 133. Both kinds of contributions were involved in *Edwards* v. *Cuba Railroad Co.*; and this Court specifically said they should be treated alike.

So here, the result is the same whether the petitioner be said to have made a capital investment in the extensions equal to the cost of construction or whether it be deemed in effect to have received them without making any personal investment and to have taken over the contributors' costs.

(2)

Assuming petitioner personally made no capital investment in the line extensions, it by no means follows that it suffers no current economic loss through depreciation subject to depreciation allowances under Section 23(l).

An owner of depreciable property actually suffers a current economic loss on that property due to the passage of time, however he may have acquired it, unless of course someone undertakes to make it good. The extent of the economic loss in any year is the amount by which the property depreciates in value during the year. Thus, if Section 23(l) presupposes an economic loss, such a loss is clearly present here. For petitioner has full ownership of the line extensions: they depreciate in value year by year through exhaustion, wear and tear; and petitioner suffers that loss since no one has covenanted to make it good. The cases relied upon by respondent are beside the point. None of them involved gifts or contributions to capital. *United States* v. *Flannery*, 268 U. S. 98, dealt with

a peculiar situation, confronted at the outset of the income tax law, in which a loss was claimed on property that had appreciated, not depreciated, in value; there no output of money had been made by anyone and no actual loss was suffered in respect of the appreciation. *Weiss* v. *Weiner*, 279 U. S. 333, and the other lease cases cited, dealt with lessees who had no present property interest to depreciate beyond their own investment or with lessors who suffered no depreciation because the lessees agreed to stand the loss—all distinguishable for the reasons given at page 34 of petitioner's main brief.

Respondent's argument that an out-of-pocket capital investment is necessary in order to obtain a depreciation deduction under the broad provisions of Section 23(l) runs squarely against the plain provisions of the statute that a donee may take depreciation.

If Jones gives Smith a plant or the money with which to build it, would Smith make a profit if he sold it at once? No, because the statute says so. The statute gives him Jones' cost.

If Smith operates the plant, does he get current deductions for depreciation currently suffered? Yes, because the statute says so. Depreciation being in substance a sale of property through use, the statute says Smith shall have Jones' cost for depreciation purposes also.

It is not believed respondent would attempt to question this. Yet Smith has made no more of a capital investment in the plant, and suffers no greater economic loss through depreciation—perhaps less, since the law would impose on him no legal obligation to maintain and replace—than does the petitioner with respect to the line extensions here. Though Smith "obtains not simply the *future* obligation of

another to make good any [depreciation] loss which might result, but obtains instead . . . the actual present assumption of that loss by another" (p. 17), he is not *a fortiori* denied depreciation deductions. On the contrary, he concededly gets such deductions under the statute.

The case at bar, though seemingly more complicated because we are dealing with regulated utility procedures, is fundamentally as simple as that in this illustration. The only other factor in either case is the effect of the motives of the contributor or of any resulting obligations incurred by the recipient, but these factors do not affect the right to depreciation under Section 23(1). They bear only upon whether the contributions, be they in money with which to build the property or in the property itself, were purchased for a consideration, in which event the purchase price would be the depreciation basis, or constituted income, gifts, or contributions to capital, in which event the basis would be the cost of construction.

If Congress had intended that a taxpayer, in order to get depreciation deductions, had to put his own money into the property, it could readily have so provided. But instead of so doing, it has carefully provided that a transferee of property without consideration takes over the cost basis of the transferor and is to be allowed depreciation on that.

(3)

Respondent passes lightly over the status of the contributions as gifts or contributions to capital. He simply says (p. 21) *a fortiorari* they were not gifts because not mere gratuities but paid to secure services which the contributors

would not otherwise be entitled to receive.[1] Relying upon *Edwards v. Cuba Railroad Co.* for his statement as to the non-gratuitous character of the contributions, he cites but fails to discuss this Court's recent decision in *Helvering v. American Dental Co.*, No. 303 this Term, decided March 1, 1943, which strongly reinforces petitioner's view that the contributions, whether or not gratuitous in the sense of donative or altruistic motive, were nevertheless gifts or contributions to capital because received without consideration.

When he comes to contributions to capital, respondent, while not denying that they may be made by nonstockholders, seeks to remove the contributions here from that category chiefly because they did not become part of "those resources whose dedication to the users of the corporation is made the foundation for the issuance of capital stock and which, as the result of the dedication, become irrevocably devoted to the satisfaction of all the obligations of the corporation" (pp. 25-26). If by this it is intended to suggest that there can be no capital contribution unless it be made

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[1] Respondent intimates in footnote 6 (p. 22) that the contributions, though paid regardless of the actual rendering of any service, and despite petitioner's legal obligation to maintain and replace, might have been taxable as income on the theory that they were given "as advance payment for services to be rendered". This of course, while not material to this case, is not strictly true. Indeed, it is less true here than in *Edwards v. Cuba Railroad Co.* where the contributor obtained direct contractual rights to reduced rates and other special privileges. Here petitioner's obligations following construction of an extension arose by operation of law. They were simply resulting legal duties imposed on it by law because it is a public utility corporation. Though the purpose of the contribution was undoubtedly to put the contributor in a position in relation to the enterprise whereby he could obtain service on demand at regular rates, petitioner's service obligations run equally to everyone in the territory adjacent to the line extension since it becomes part of its expanded distribution system.

the basis for a stock issue, the suggestion is clearly wrong. The statute, Section 113 (a)(8)(A) and (B), refers to transfers in exchange for stock, to contributions to paid-in surplus and to contributions to capital; and each must be given effect. If the statement simply means that the thing contributed must become a company asset, that factor is present here. And finally, the requirement that the contribution be irrevocably devoted to the satisfaction of all petitioner's obligations is open to serious question. As to this requirement, one of two alternatives seems inescapable. (a) If mechanics are controlling, the test is met, though we need not be concerned with it. For the cash contributions though given for a capital purpose were not earmarked and became available to petitioner for any use whatsoever, it having constructed the extensions out of its general working funds at a cost equal to the amount expended. (b) If substance is controlling, the test is also met as fully as can ever be the case with a contribution of property in kind. Precisely as in the case of a contribution of a line extension itself, the cash with which to build one is contributed in order to bring about an addition to the permanent capital assets of the petitioner. The purpose being to contribute something to the permanent capital of the enterprise, the requirements of a capital contribution contemplated by Section 113(a)(8)(B) of the statute and Article 113(a)(8)-1 of Regulations 94 are fulfilled. Considering the company as an economic unit, there can be no distinction in this regard between contributions by stockholders and third parties.

The second alternative represents the view expressed by this Court in *Edwards* v. *Cuba Railroad Co.*, which respondent fails to refer to in connection with this point. In-

deed, in that case this Court pointed out that the very fact that the contributions were intended to be used for capital purposes and not for dividends, operating expenses and the like was a controlling reason why they were contributions to capital and not income. *Cf.* Some Indicia of Capital Transfers Under the Federal Income Tax Laws, 37 Mich. L. R. 745; Mertens, Law of Federal Income Taxation, 1939 Cumulative Supplement, par. 5.32A, page 89. This view was reaffirmed by this Court in 1932 in *Texas & Pacific Railway Co.* v. *United States*, 286 U. S. 285. In holding certain payments under Section 209 of the Transportation Act of 1920 to be income, this Court there distinguished the *Cuba Railroad* case by saying (p. 289):

> "The sums received under the act were not subsidies or gifts,—that is, contributions to the capital of the railroads,—and this fact distinguishes cases such as *Edwards* v. *Cuba Railroad Co.* * * *, where the payments were conditioned upon construction work performed. Here they were to be measured by a deficiency in operating income, and might be used for the payment of dividends, of operating expenses, of capital charges, or for any other purpose within the corporate authority, just as any other operating revenue might be applied."

In the Board cases involving non-taxability of third party contributions, the contributions appear to have been regarded as gifts or contributions to capital since they were not income, irrespective of whether they were made in money with which to erect property or in the property itself. In the leading case of *Liberty Light & Power Co.*, 4 B. T. A. 155, for example, it was said that the contributions "were contributed by the citizens to the capital of the

taxpayer";[2] and in this and other decisions following it respondent has acquiesced. Indeed, respondent's general counsel has publicly consistently described such contributions as gifts or contributions to capital. *G. C. M. 1581*, VI-1 C. B. 197 (1927), and *G. C. M. 16952*, 1937-1 C. B. 133.[3]

No other alternative is possible. The purely adjective provision, Section 113(b)(1)(A), which the Court below brought into play with respect to the cash, and which could not possibly apply to property contributions for identical purposes, is not controlling for the reasons set forth in petitioner's main brief (pp. 29-32). These reasons respondent has not even attempted to meet.

(4)

Respondent complains of a double benefit, urging that since the contributions were not taxable, consistency in treatment requires that depreciation be disallowed on the contributed property in order to reflect petitioner's true

---

[2]While *Frank Holton & Co.*, 10 B. T. A. 1317, and *Tampa Electric Co.*, 12 B. T. A. 1002, held that such contributions did not become part of invested capital under the war profits and excess profits tax laws of 1918 and 1921, that was because those laws, differing from the present income tax and excess profits tax laws, specifically defined invested capital in Section 326(a) as including only amounts paid in for shares and paid-in surplus. Contributions to capital and gifts were not taken into account.

[3]In footnote 6, respondent refers to private information received from unnamed sources with respect to past Treasury practice. Petitioner has no opportunity to ascertain whether the information is authoritative or represents half truths or whole truths. But it seems evident, from the inquiries that have been made of it and the interest shown by other taxpayers in this case, that, like the petitioner, others similarly situated do not acquiesce in the Treasury's current position.

income (pp. 22, 26). He thus in effect seeks to renew the old fight over the taxability of third party contributions. For the reasons given under Point III of petitioner's main brief, there would be no resulting double benefit here; but even if there were, the question of double benefit is wholly irrelevant. In the last analysis, respondent's real complaint is that the tax statute allows taxpayers to receive property without consideration and still take depreciation on it. In reality this is no different from giving a taxpayer a basis for property for which he paid nothing in determining the tax consequences of its sale, which the Revenue Act also does.

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April, 1943.

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No. 675

In the Supreme Court of the United States

OCTOBER TERM, 1942

THE DETROIT EDISON COMPANY, PETITIONER

v.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SIXTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT

In the Supreme Court of the United States

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MEMORANDUM FOR THE RESPONDENT

The court below stated (R. 61) that the result reached by it was in conflict with *Arundel-Brooks Concrete Corp.* v. *Commissioner*, 129 F. 2d 762 (C. C. A. 4). Although the conflict is not too clear since these cases involved different factual situations, it would nevertheless be helpful in the administration of the statute to have the question authoritatively settled by this Court. We accordingly do not oppose the petition.

Respectfully submitted.

CHARLES FAHY,
Solicitor General.

FEBRUARY, 1943.

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No. 675

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October Term, 1913

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BRIEF FOR THE RESPONDENT

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In the Supreme Court of the United States

OCTOBER TERM, 1942

No. 675

THE DETROIT EDISON COMPANY, PETITIONER

v.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SIXTH CIRCUIT

BRIEF FOR THE RESPONDENT

OPINIONS BELOW

The opinion of the United States Board of Tax Appeals (R. 38–42) is reported in 45 B. T. A. 358. The opinion of the Circuit Court of Appeals (R. 47–54) is reported in 131 F. 2d 619.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on November 30, 1942 (R. 47). The petition for a writ of certiorari was filed on January 26, 1942, and was granted on March 1, 1943 (R. 55). The jurisdiction of this Court rests upon

Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Where taxpayer agreed to supply electric energy to consumers in outlying areas only upon condition that the necessary extension lines would be built or paid for by the consumers, is taxpayer entitled to a deduction for depreciation of such lines under Section 23 (l) of the Revenue Act of 1936?

STATUTE AND REGULATIONS INVOLVED

The pertinent statutory provisions and regulations are set forth in the Appendix, *infra*.

STATEMENT

This case involves petitioner's income tax liability for the years 1936 and 1937, and more particularly, its right to depreciation deductions with respect to certain facilities constructed with funds contributed by its customers. The facts, as stipulated (R. 15–37) and as found by the Board of Tax Appeals (R. 38–41), may be stated as follows:

The petitioner is a New York corporation, licensed to do business in Michigan (R. 15, 38). It is a public utility engaged, among other things, in the generation and sale of electric energy in and around the City of Detroit, and operates under the jurisdiction of the Michigan Public Service Commission (R. 16, 38).

In connection with the distribution and sale of electric energy, petitioner from time to time receives applications for the extension of its transmission or distribution lines to places which in its opinion are situated too far from existing transmission or distribution lines to warrant the expenditures necessary to make such extensions (R. 16, 38–39). Nevertheless, if the applicant agrees to pay the estimated cost of construction, it has been petitioner's practice to agree to provide the desired extension. The agreement between the petitioner and the applicant is evidenced by one of five types of contracts, which are reproduced in full in the stipulation of facts herein (R. 16, 21–37, 39).

The amount of the payment made by the applicant is the estimated cost, and not the actual cost, but it never exceeds the actual cost of constructing the requested line extension, and no increase or decrease is made in the amount fixed in the contract upon the completion of the line extension by reason of the actual cost thereof (R. 16, 39). In two of the form contracts (types III and V, R. 28–31, 35–37) there are no provisions for any refunds to the applicant. In the remaining three, the company agrees that it will over a period of five years refund annually either one-half of the revenues derived from the extension (types I and II, R. 21–28) or $60 for each additional customer served by the extension (type IV, R. 31–34); in

no event, however, may the aggregate refund exceed the original contribution, and no additional refunds may be made after the expiration of the five-year period.

The material and property used in the construction of the line extension and the cost of labor are in all cases paid from the general working funds of the petitioner. The records of the petitioner set forth and identify all work performed and to be performed under the provisions of any given contract (R. 16; 39). Upon the completion of the line extension, the petitioner, in accordance with standard practice, enters upon its books as a "property item" (such as poles, lines, etc.), the cost of the line extension, including labor and material, and does not subtract from that sum the amount of the payment made by the applicant (R. 17, 39).

The cash payment made by the applicant in those contracts providing for refunds is not earmarked for the building of any given line extension, but upon its receipt becomes a part of the free working capital of the petitioner. However, the cash payment is entered in what is apparently a suspense account identified as "Customers' Deposits for Line Extensions," and after the five-year period has elapsed the portion remaining unrefunded is transferred to surplus through the medium of an account identified as "Contributions for Extensions." And in the

case of the contracts which do not provide for refunds the cash payment is entered at once in the latter account (R. 17–18, 39–40).

During the years 1936 and 1937 the petitioner thus credited $36,065.81 and $47,500.67 to surplus which represented the balance of customers' payments which became unrefundable in each of those years, respectively (R. 20, 40). Petitioner did not report, nor did the Commissioner seek to tax those amounts as income (R. 20, 40).

The Commissioner did determine, however, that the petitioner was not entitled to depreciation with respect to that portion of the cost of the line exensions represented by the unrefunded balances. The unrefunded (and unrefundable) balances of the deposits at the close of each of the years 1935, 1936, and 1937 were as follows (R. 19, 40):

1935	$1,148,679.86
1936	1,184,745.67
1937	1,232,240.34

The elimination of the unrefunded balances from the depreciable base[1] resulted in a disallowance of depreciation deductions for 1936 and 1937 in the respective amounts of $40,273.11 and $41,786.26 (R. 21, 41). The Board of Tax Ap-

[1] In determining the deficiencies, the Commissioner excluded from the depreciable base the mean of those balances between the beginning and close of each of the taxable years 1936 and 1937. Thus, he eliminated $1,166,712.77 from the base for 1936, and $1,208,496.01 for 1937.

peals sustained the Commissioner's determination (R. 38–42), and the Circuit Court of Appeals affirmed (R. 47–54).

SUMMARY OF ARGUMENT

Section 23 (l) of the Revenue Act of 1936 authorizes a deduction on account of depreciation, and Sections 113 and 114 prescribe the basis for computing that deduction, i. e., Section 23 (l) determines *whether* the deduction is allowable, and Sections 113 and 114 determine *how much* the deduction shall be.

A deduction for a depreciation allowance is permitted by Section 23 (l) only where the claimant actually suffers depreciation. Depreciation can be said to be suffered by the claimant only where it bears the burden of the economic loss due to the exhaustion of the property. Petitioner here, having agreed to furnish electric energy to consumers in outlying areas upon the sole condition that such consumers would build or pay for the necessary extension lines, has made no capital investment on which it is suffering a present economic loss. The very purpose of the arrangement with petitioner's consumers was to relieve petitioner of the burden of making any capital investment and suffering a loss thereon.

The mere existence of an obligation on the part of petitioner to replace the lines in the

future does not satisfy the requirement that it shall have made a capital investment on which it is suffering a present loss. If and when petitioner does replace these facilities it will thereafter be entitled to depreciation deductions measured by the cost of such replacement.

The basis provisions in Sections 113 and 114 furnish further support for our position that no depreciation is allowable here under Section 23. Section 113 (a) deals with an "unadjusted basis," while Section 113 (b) prescribes the use of an "adjusted basis" which is expressly made applicable to the depreciation deduction by Section 114. And in spelling out the method of determining the "adjusted basis," subdivision (1) (A) of Section 113 (b) explicitly requires in sweeping language that proper adjustment in basis shall be made for "expenditures, receipts, losses, or other items, properly chargeable to capital account." The contributions by petitioner's customers in this case were certainly "receipts" within the meaning of the foregoing provisions, and must therefore be carved out of the basis of the property in question.

Neither Section 113 (a) (2) dealing with "gifts," nor Section 113 (a) (8) dealing with "contribution to capital" requires a different result.

If petitioner is allowed the depreciation deduction claimed, not only will it reap the benefit of an expense which it expressly refused to bear, but

the result will be that the payments in question, having escaped taxation when received, would be used again to exempt from taxation earned income which would otherwise be taxable. Such a result was never intended by the applicable statutory provisions.

ARGUMENT

PETITIONER, HAVING MADE NO CAPITAL INVESTMENT IN THE LINE EXTENSIONS BUILT OR PAID FOR BY ITS CONSUMERS, IS SUFFERING NO ACTUAL LOSS THROUGH DEPRECIATION OF SUCH LINES AND IS THEREFORE ENTITLED TO NO DEPRECIATION DEDUCTION THEREON

1. Section 23 (l) of the Revenue Act of 1936 (Appendix, *infra*) provides that in computing net income there shall be allowed as a deduction a reasonable allowance for the exhaustion, wear and tear of property used in the taxpayer's trade or business. If depreciation is thus to be allowed a taxpayer by virtue of Section 23 (l), then Sections 114 and 113 of the Revenue Act (Appendix, *infra*) outline the basis upon which the depreciation allowance is to be computed. See Treasury Regulations 94, Article 23 (l)-1, Appendix, *infra*. In other words, Section 23 (l) determines *whether* depreciation is to be allowed, and Sections 114 and 113 prescribe the basis to be used in determining *how much* depreciation is to be allowed. Cf. *United States* v. *Ludey*, 274 U. S. 295. Since the income tax law is concerned only with losses that are actually realized (cf. *Lucas* v. *American Code Co.*, 280 U. S. 445, 449), in determining whether depreciation is to be allowed within the meaning

of Section 23 (l), there is in addition to the conditions explicitly set forth in that section, the further inherent prerequisite that the claimant actually *suffer* depreciation—that is, that the burden of the economic loss due to the exhaustion, wear and tear of the property actually be borne by it. The basis provisions in Sections 113 and 114 merely specify the measure of the deduction on account of loss, depreciation, etc. They do not determine whether the deduction is allowable.

The distinction is well established. In *United States* v. *Flannery*, 268 U. S. 98, the taxpayer had purchased certain stock prior to March 1, 1913, and had sold it in 1919 for more than its cost but for less than its value on March 1, 1913. The provisions of the applicable revenue act corresponding to Section 113 herein, provided that the basis of property acquired prior to March 1, 1913, should be its value as of that date. Thus, although the taxpayer actually realized a profit upon sale in 1919, he claimed a deductible loss because the sale price was less than the basis (i. e., the March 1, 1913, value) of the stock. This Court held, however, that the basis provisions could not be utilized to provide a deduction on account of loss unless it is first established that there is an actual loss. Compare *McCaughn* v. *Ludington*, 268 U. S. 106; *Helvering* v. *Owens*, 305 U. S. 468.

2. The foregoing principles are fully applicable to deductions for depreciation. It has frequently

been held, both by this Court and the lower courts, that the taxpayer must show an actual impairment or diminution or exhaustion of his capital investment in order to establish a right to the deduction. It is therefore clear that depreciation cannot be allowed where the taxpayer has made no capital investment in the property, for his capital investment is not being impaired. Thus, in *Weiss v. Wiener*, 279 U. S. 333, the lessee of a 99-year lease undertook to maintain buildings on the leased premises in their original condition, but had not as yet made any payments for the estimated depreciation. In denying to the lessee a deduction for depreciation claimed under statutory provisions identical with Section 23 (l), this Court, speaking through Mr. Justice Holmes, said (p. 336):

> But it is very clear that as yet the capital of the lessee has not gone into it, and upon the considerations just mentioned it is not enough that he has made a contract that very possibly may not be carried out to replace that capital at some future time. If, as we think, such a contract is not enough to cause the lessee a present loss by wear and tear, the fact, which may be assumed, that the property was used by him in his business, does not matter. Of course he must show an interest in the property *and a present loss to him* to make the statute apply. [Italics supplied.]

To the same effect see *New York Cent. R. Co.* v. *Commissioner*, 79 F. 2d 247 (C. C. A. 2d), certiorari denied, 296 U. S. 653; *Tunnel R. R.* v. *Commissioner*, 61 F. 2d 166 (C. C. A. 8th), certiorari denied, 288 U. S. 604; *Belt Ry. Co.* v. *Commissioner*, 36 F. 2d 541 (App. D. C.), certiorari denied, 281 U. S. 742; *Brevoort Hotel Co.* v. *Reinecke*, 36 F. 2d 51 (C. C. A. 7th). Cf. *City Nat. Bank Bldg. Co.* v. *Helvering*, 98 F. 2d 216 (App. D. C.). On the other hand, however, if the lessee actually makes the capital investment in the depreciating property, he thereafter suffers a present economic loss through the exhaustion thereof, and is entitled to an annual allowance for depreciation. *Duffy* v. *Central R. R.*, 268 U. S. 55. See also *George H. Bowman Co.* v. *Commissioner*, 32 F. 2d. 404 (App. D. C.); *Kaufman-Straus Co.* v. *Lucas*, 12 F. 2d 774 (C. C. A. 6th); cf. *National City Bank of Seattle* v. *United States*, 64 C. Cls. 236, certiorari denied, 276 U. S. 620. Conversely, in a situation such as that presented in *Weiss* v. *Wiener*, it has been uniformly held that the lessor also is entitled to no depreciation allowance, since although such lessor may have originally made a capital investment, it suffers no present loss thereon because the lessee has covenanted to make that loss good. *Atlantic Coast Line R. Co.* v. *Commissioner*, 81 F. 2d 309 (C. C. A. 4th), certiorari denied, 298 U. S. 656; *Georgia Ry. & Electric Co.* v. *Commissioner*, 77 F. 2d 897 (C. C. A. 5th), cer-

tiorari denied, 296 U. S. 601; *Commissioner* v. *Terre Haute Elec. Co.*, 67 F. 2d 697 (C. C. A. 7th), certiorari denied, 292 U. S. 624; cf. *Terre Haute Electric Co.* v. *Commissioner*, 96 F. 2d 383 (C. C. A. 7th).

It is apparent, therefore, that petitioner in the instant case, before it can successfully claim an allowance for depreciation, must establish the fact that it has made a capital investment in the property involved, and that it is suffering a present actual loss due to the depreciation of that investment. The mere fact that petitioner may have had legal title to the depreciating equipment, used in its trade or business, will not suffice to permit it a deduction for depreciation if it cannot show that it is sustaining a present loss through the depreciation of a capital investment which it has made. *Atlantic Coast Line R. Co.* v. *Commissioner, supra; Georgia Ry. & Electric Co.* v. *Commissioner, supra; Commissioner* v. *Terre Haute Electric Co., supra.* See also *Barbour* v. *Commissioner*, 44 B. T. A. 1117, 1121; *Gladding Dry Goods Co.* v. *Commissioner*, 2 B. T. A. 336, 337. Similarly, the absence of legal title will not prevent its taking the deduction if it were actually suffering a present loss of its own capital investment. *Duffy* v. *Central R. R., supra;* cf. *Helvering* v. *Lazarus & Co.*, 308 U. S. 252; and cf. *Colony Coal & Coke Corp.* v. *Commissioner*, 52 F. 2d 923 (C. C. A. 4th). Likewise

not controlling on the question of whether taxpayer is entitled to a depreciation allowance is the existence or absence of a future obligation on the part of taxpayer to replace the depreciating property at the expiration of its useful life. If it has made the capital investment and is suffering the loss thereon, it will, if it meets the other requirements of the statute, be allowed depreciation, although in fact it may not be obligated to replace that investment. If it has made no capital investment, the mere existence of a future obligation to replace the property will not suffice to give it a depreciable interest in that property. *Weiss* v. *Wiener, supra.* If, as, and when it fulfills that future obligation to replace and makes its own investment, from that time on, but not before, will it begin to suffer a loss. *New York Cent. R. Co.* v. *Commissioner, supra,* p. 251; *Belt Ry. Co.* v. *Commissioner, supra,* p. 542.

3. It is the Government's contention that petitioner here has made no capital investment in the property on which it seeks a depreciation allowance. As a result, it cannot be said that it is suffering a present loss on any capital investment made by it, and it is therefore entitled to no deduction for depreciation within the meaning of Section 23 (l) of the Revenue Act of 1936.

The facts reveal that the petitioner, in connection with the distribution and sale of electric

energy, from time to time receives applications for extensions of its transmission or distribution lines to places which, in petitioner's opinion, are situated too far from its existing lines to warrant expenditure of the amounts necessary to make such extensions. In such case petitioner, prior to the construction of the desired extension, requires the applicant to pay to it a sum representing the estimated cost of such construction. It is obvious, therefore, that the very purpose of the arrangement made by taxpayer with its applicants is to relieve taxpayer of the burden of making an investment of its own capital.[2] Only if that burden were assumed by the applicants would the taxpayer consent to enter into any agreement to furnish such applicants electrical energy. And yet having successfully shifted the burden of the required capital investment to its consumers,[3] taxpayer insists

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[2] Each of the contracts under which the consumers agreed to pay for the cost of required additional extension lines provided (R. 21-22, 25, 28-29, 31-32):

"Whereas, the Company *does not consider warranted at the present time the investment in poles, wires, etc., necessary* to extend its lines to the place where the said service is desired;

"Therefore it is Agreed * * *. [Italics supplied.]

[3] Petitioner's Account No. 255, to which were credited all sums contributed by applicants and which were not to be refunded, reads in part as follows (R. 17):

"To this account shall be credited contributions in money or property made to the accounting company *for the purpose of assuming the burden of* [*sic*] *any part of the burden*

that the loss due to the depreciation of that investment is being suffered by it. In other words, the very loss which it expressly refused to assume, it now asserts that it did assume. The taxpayer's contention is, in effect, that the present situation is to be treated precisely the same as if it had required no contribution from its consumers, but had instead agreed to invest its own capital in building the property in question.

It is true that taxpayer has legal title to the property, which is being used in its business; but as has been previously pointed out, this fact alone is not sufficient to establish the prerequisite of a present loss in a capital investment. *Atlantic Coast Line R. Co.* v. *Commissioner, supra; Georgia Ry. & Electric Co.* v. *Commissioner, supra; Commissioner* v. *Terre Haute Electric Co., supra.*

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represented by the investment necessary for the establishment or extension of services rendered by the company. This covers such items as contributions toward the cost of line extensions in sparsely settled territory made by consumers, either voluntarily or when reasonably required by the company as a condition of giving the desired service, and the cost of services to which the company has title, in so far as *such cost is borne by the consumer;* * * *." [Italics supplied.]

'It is pertinent to note that in respect of the poles furnished and owned by the applicants in accordance with the contract set out in Exhibit V (R. 35), taxpayer seems quite willing to concede that it is entitled to no depreciation upon such property, although obligated to replace it. As to this property, taxpayer in its reply brief below declared (p. 5), "The utility could not take depreciation, for it does not own the property and suffers no depreciation on it." But, as has

It may be likewise true that the taxpayer is obligated to replace the extension lines when their useful life is ended; but, again, the existence of such future obligation does not suffice to establish a capital investment upon which a present actual loss is being suffered. *Weiss* v. *Wiener, supra.* Cf. *Brown* v. *Helvering*, 291 U. S. 193. When the taxpayer fulfills that obligation and in fact makes its own capital investment, it will thereafter be entitled to a depreciation allowance. *New York Cent. R. Co.* v. *Commissioner, supra; Belt Ry. Co.* v. *Commisisoner, supra.* Until such time, however, it cannot be said to be suffering a present loss through the depreciation of property in which it has refused to make any capital investment. The existence of a capital investment imports the laying out of money or money's worth for the acquisition of an asset for use in the business, and it is the very laying out of such money for the acquisition of a capital investment which petitioner expressly did "not consider warranted at the present time." Cf. *LaBelle Iron Works* v. *United States*, 256 U. S. 377, 388; see also *Steele-Wedeles Co.* v. *Commissioner*, 63 F. 2d 541 (C. C.

been previously pointed out, the question of whether a claimant suffers depreciation depends not simply upon whether it has legal title to the property, but upon whether it is incurring a present loss due to the depreciation of a capital investment which it has made. If taxpayer here suffers no depreciation upon the property furnished in accordance with Exhibit F, it is difficult to understand how it suffers depreciation upon any of the other property here involved.

A. 7th). Cf. *Golden Cycle Corp.* v. *Commissioner*, 51 F. 2d 927 (C. C. A. 10th). It is manifest that before it entered into the contracts with its consumers, taxpayer had no capital investment. At the expiration of the life of the property paid for by the applicants it will also have no investment. In the interim, it is not bearing the burden of any present loss.

Had petitioner here invested its own capital in erecting the extension lines in question, and leased such lines to its consumers, the latter agreeing to replace the property at the expiration of its useful life, it seems clear that taxpayer would not be suffering a present loss due to the depreciation of such property because of the agreement on the part of the lessee-consumer to make that loss good. *Atlantic Coast Line R. Co.* v. *Commissioner, supra; Georgia Ry. & Electric Co.* v. *Commissioner, supra; Commissioner* v. *Terre Haute Electric Co., supra.* If the existence of a future obligation on the part of a third party to make good any loss resulting from the depreciation of the claimant's capital investment is sufficient to preclude the latter from taking an allowance for depreciation, it would appear *a fortiori* that a claimant, who obtains not simply the *future* obligation of another to make good any loss which might result, but obtains instead, as did taxpayer here, the actual present assumption of that loss by another, is entitled to no allowance for depreciа-

tion. Taxpayer here is, we submit, precisely in the same position it would have been in had it used its own funds to build the lines in question and had then been immediately reimbursed by its applicants for the sums expended. The fact that payment by the consumers was required before petitioner would consent to construct the necessary lines cannot alter the substance of the transaction. In either case, taxpayer has already recovered any loss which it might otherwise have suffered.

Had the applicants in the instant case agreed not only to make the original capital investment required to build the extension lines, but also to contribute periodically amounts required for the repair and maintenance of such lines, it seems clear that petitioner would not be permitted to deduct the cost of those repairs as an ordinary and necessary expense of its business. Cf. *New York, C. & S. L. R. R. Co.* v. *Helvering*, 71 F. 2d 956 (App. D. C.); and cf. *Glendinning, McLeish & Co.* v. *Commissioner*, 61 F. 2d 950 (C. C. A. 2d). Since depreciation is, after all, nothing more than an operating expense of a business incurred by reason of the exhaustion of capital assets used in that business (*Gambrinus Brewery Co.* v. *Anderson*, 282 U. S. 638, 643), there would appear to be no reason why petitioner should be permitted to deduct such an operating expense when that expense was never borne by it. If in the present case petitioner's applicants had agreed

to pay for or erect not a permanent extension line system, with an anticipated useful life of say, 30 years, but had instead agreed to pay for the cost of constructing each year for a period of 30 years a temporary structure which was expected to endure for one year only, the expense so borne by the consumer obviously could not have been properly deducted by petitioner as an operating expense of petitioner's business. We submit that the mere fact that the expense suffered in the instant case is in the form of depreciation cannot serve to alter the fundamental fact that it is an expense not suffered by the petitioner.

4. We have thus far endeavored to show that the taxpayer is not entitled to a depreciation deduction under Section 23, and we have therefore not considered the provisions in Sections 113 and 114 which merely prescribe the basis for computing the deduction if it is otherwise allowable under Section 23. However, there is nothing in those basis provisions which contradicts our position, and indeed they go far to confirm its correctness.

(a) Section 114 (a) is captioned "Basis for Depreciation," and it declares that the basis upon which depreciation (i. e., "exhaustion, wear, and tear") is to be allowed shall be "the adjusted basis provided in Section 113 (b) for the purpose of determining the gain upon the sale or other disposition" of the property.

It is to be observed that Section 113 (a) deals with an "unadjusted basis," while Section 113 (b) prescribes the use of an "adjusted basis." Obviously a significant difference was intended between the two. And Section 113 (b) (1) indicates an intention to give the very broadest scope to adjustments, so that the computation would accurately reflect the taxpayer's true income. Thus, Section 113 (b) (1) (A) provides:

> (1) GENERAL RULE.—Proper adjustment in respect of the property shall in all cases be made—
>
> (A) for expenditures, *receipts*, losses, or other items, properly chargeable to capital account, including taxes and other carrying charges on unimproved and unproductive real property; but no such adjustment shall be made for taxes or other carrying charges for which deductions have been taken by the taxpayer in determining net income for the taxable year or prior taxable years. [Italics supplied.]

These provisions plainly contemplate that receipts and expenditures with respect to the taxpayer's property may have a critical bearing upon the taxpayer's net investment in the property. As the court below remarked (R. 51), "All expenditures having some reasonable relationship to the asset are a part of its cost and likewise all receipts having some reasonable relationship to the asset, must be deducted from the cost."

The contributions by petitioner's customers were "receipts" within the meaning of Section 113 (b) (1) (A) which certainly had a very direct relationship to the cost of the facilities, and adjustments in those amounts are therefore unambiguously required by those provisions.

(b) Nor may a different result be reached here by treating the amounts received by petitioner as "gifts" under Section 113 (a) (2) which requires a donee to take over the basis of his donor.[3] The contributions here in issue were not "gifts" within the meaning of Section 113 (a) (2). In *Edwards v. Cuba Railroad*, 268 U. S. 628, 632, this Court pointed out that contributions made "in order to induce construction and operation of railroads for the service of the public are not given as mere gratuities." *A fortiori*, the facilities involved in the instant inquiry, being paid for by the consumers in order that they might secure services which they were not otherwise entitled to receive, are not gifts as contemplated

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[3] Section 113 (a) (2) of the Revenue Act of 1936 provides that in the case of property acquired by gift after December 31, 1920, the basis shall be the same as it would be in the hands of the donor, except that for determining loss the fair market value of the property at the time of the gift shall be used, if lower. The theory of permitting a donee to take depreciation is simply that such donee steps into the shoes of the donor, whose capital investment becomes that of the donee. Cf. *Taft v. Bowers*, 278 U. S. 470 and cf. *Helvering v. Falk*, 291 U. S. 183; but see *Anderson v. Wilson*, 289 U. S. 20.

in the provisions of the Revenue Act relating to gifts.[6] Cf. *Helvering* v. *American Dental Co.*, No. 303, this Term, decided March 1, 1943.

It does not follow that because the payments received by taxpayer were not gifts to it, that the value of those amounts must be treated as the "cost" to taxpayer[7] of the property which it

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[6] Although all of the amounts paid to petitioner have escaped taxation on the authority of *Edwards* v. *Cuba Railroad*, *supra*, it would seem that, unlike the contributions involved in the *Cuba Railroad* case, the amounts furnished to petitioner here are really given as advance payment for services to be rendered. As such they might well be considered taxable income to petitioner when received. Cf. *Texas & Pacific Ry. Co.* v. *United States*, 286 U. S. 285; *Continental Ins. Co.* v. *United States*, 286 U. S. 290; cf. *Helvering* v. *Braun*, 309 U. S. 461. Moreover, there is substantial doubt as to the correctness of the *Cuba Railroad* case, in view of its sweeping ruling that the amounts in question were not *constitutionally* income, and that doubt is underscored not only by the foregoing decisions, but also by such cases as *Boston Elevated Railway Co.* v. *Commissioner*, 131 F. 2d 161 (C. C. A. 1), certiorari denied, No. 609, this Term, and *Helvering* v. *Claiborne-Annapolis Ferry Co.*, 93 F. 2d 875 (C. C. A. 4). However, the Board of Tax Appeals had ruled in cases of this type that the amounts received do not constitute income under the authority of the *Cuba Railroad* case (see, *e. g.*, *Liberty Light & Power Co.* v. *Commissioner*, 4 B. T. A. 155), and the Commissioner was therefore warranted in acquiescing in the taxpayer's treatment of these amounts as tax-exempt. But consistency in treatment at the same time required, in order to reflect the taxpayer's true income, that these amounts be excluded from the depreciable base. And we are informed that such has been the Treasury's consistent practice for at least the past twelve years.

[7] In *Arundel-Brooks Concrete Corp.* v. *Commissioner*, 129 F. 2d 762 (C. C. A. 4th), the court held that the total cost

acquired as a result. The consideration given by petitioner in exchange for the sums advanced by its consumers was the relinquishment by it of its right to refuse to furnish electric energy to those consumers. That consideration cost petitioner nothing.[8] To say here that the "cost" to petitioner of the properties in question is the cost which the consumers paid for those properties produces the anomalous result of saying that the cost to petitioner is what it would have been had petitioner expended its own funds to build the line extensions. If the properties "cost" petitioner the same amount that it would have cost it had no payment been required from its consumers, it is difficult to understand why such payment was required to be made at all. It seems perfectly apparent that the cost of these properties was borne by the consumers, not petitioner; under no other circumstances would petitioner have agreed to furnish electrical energy. To the extent that the properties in question were paid for by

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of the property, by whomever paid, not the cost to the taxpayer, was the proper basis to be used in computing depreciation. It would seem fundamental; we think, that since it is the taxpayer's net income which is subject to income tax, only the costs which it bears should be pertinent in determining its taxable net income.

[8] The "cost" to a taxpayer of property acquired is to be measured not by the value of the property, but by the cost to the taxpayer of what it gave in order to obtain the property. For example, a taxpayer who pays $1,000 for property worth $10,000 has a cost basis of only $1,000.

the consumers, it cannot be said that those properties cost petitioner anything. *Kell* v. *Commissioner*, 88 F. 2d 453 (C. C. A. 5th); *Nashville Warehouse & El. Corp.* v. *Commissioner*, 105 F. 2d 883, 885 (C. C. A. 6th).[10] See also *North American Coal Corp* v. *Commissioner*, 28 B. T. A. 807, 848; cf. *Friend* v. *Commissioner*, 119 F. 2d 959 (C. C. A. 7th), certiorari denied, 314 U. S. 673.

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[9] *Robinson* v. *Commissioner*, 97 F. 2d 552 (C. C. A. 9th), upon which taxpayer relies (Br. 22-25), is not inconsistent. It involved the question of determining the amount of gain realized from the sale of bonds and stock, and the Commissioner's determination fixing the basis of the bonds and stock at precisely the amount of funds which the taxpayer had expended from his own pocket was sustained.

[10] There were two issues involved in this case. As to the second issue, it appears that the taxpayer contracted with another company to erect certain bins and tanks, $140,000 of the cost of which was to be paid by such other company. It was held that only one amount in excess of $140,000 which was paid for by taxpayer could be considered as its cost basis. As to the first issue, the facts revealed that the taxpayer purchased certain property for $40,000, payable in installments, and paid all but about $13,000 of the purchase price out of the proceeds of fire insurance collected upon the destruction of the property. We submit that the decision of the court holding that the cost of the property to the taxpayer was $40,000 offers no support to petitioner's claim here. Had the taxpayer used $27,000 of the insurance proceeds to purchase a new capital asset rather than pay the purchase price on the destroyed property, clearly that $27,000 would have formed a part of its cost basis. In either case it has made a capital investment with its own funds.

Helvering v. *Gowran*, 302 U. S. 238, is analogous. There, the owner of common stock in a corporation received a dividend in preferred stock of the same corporation which was not taxable under the applicable revenue act. He thereafter sold the preferred stock, and was required to report the entire proceeds as income since the Court held that the preferred stock had a "zero" basis. Similarly, here, the taxpayer may not include in the basis of its property that which does not represent its own expenditures.

(c) Finally, there is no foundation for the suggestion that this case is ruled by Section 113 (a) (8) (B) which provides that property acquired by a corporation as a "contribution to capital" retains the basis which it had in the hands of the transferor. In the first place, the provision is literally not applicable because the customers did not transfer the facilities themselves to the taxpayer. In the second place, and more significantly, the amounts in question were not "contributions to capital." Normally, a contribution to capital is regarded as referring to amounts paid in by stockholders or by persons having a proprietary interest in the enterprise. And even if the concept be extended beyond its traditional scope to include contributions by outsiders, it nevertheless can have no application here. For, as indicated by the court below (R. 53), the amounts in question did not become part of "those resources whose dedication to the users

of the corporation is made the foundation for the issuance of capital stock and which, as the result of the dedication, become irrevocably devoted to the satisfaction of all the obligations of the corporation." No such situation existed here. The consumers in no sense made any such contribution. If the company had failed to construct the facilities in question, the consumers would doubtless have been entitled to a refund of the entire amount of the contributions. There is nothing in the regulations relied upon by petitioner (Treasury Regulation 94, Article 113 (a) (8)–1, see Appendix, *infra*, p. 30) which requires any such extraordinary treatment, and the Treasury itself has not so regarded them.

In the final analysis, petitioner is really seeking a double tax benefit from the same transaction. The amounts received from the consumers were not included in its taxable gross income and it seeks at the same time to take a deduction by reason of the gradual exhaustion of the facilities purchased with those funds. Cf. *Hort* v. *Commissioner*, 313 U. S. 28. Such practice is plainly not permitted for rate-making purposes, for the contributions must either be excluded from the rate base or they must be included in the company's earnings. *Re The Detroit Edison Co.*, 16 P. U. R. (N. S.) 59 (Michigan, 1936); *Re Harmony Electric Co.*, P. U. R. 1933A 306

(Michigan, 1932); *Re Northern Power Co.*, P. U. R. 1933C 128, 131 (Michigan, 1932). The result should not be any different for tax purposes, and it should not be presumed that Congress intended otherwise unless its intention were clearly expressed. Not only is petitioner seeking the benefit of an expense which it expressly refused to bear, but the net effect of upholding its claim would be that the payments in question, having escaped taxation when received, would be used again to exempt from taxation earned income which would otherwise be taxable. Certainly, there is no such expression of a legislative purpose to permit the windfall sought herein, and such an intention is "never lightly to be inferred". Cf. *Heiner* v. *Colonial Trust Co.*, 275 U. S. 232, 235.

CONCLUSION

The decision of the court below is correct and should be affirmed.

Respectfully submitted.

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APRIL 1943.

APPENDIX

Revenue Act of 1936, c. 690, 49 Stat. 1648:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * * * *

(l) *Depreciation.*—A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence. * * *

* * * * * * *

(n) *Basis for Depreciation and Depletion.*—The basis upon which depletion, exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be as provided in section 114.

* * * * * * *

SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

(a) *Basis (Unadjusted) of Property.*—The basis of property shall be the cost of such property; except that—

* * * * * * *

(2) *Gifts after December 31, 1920.*—If the property was acquired by gift after December 31, 1920, the basis shall be the same as it would be in the hands of the donor or the last preceding owner by whom it was not acquired by gift, except that for the purpose of determining loss the basis shall be the basis so determined or the fair market value of the property at the time of the gift, whichever is lower. * * *

* * * * * * *

(4) *Gift or transfer in trust before January 1, 1921.*—If the property was acquired

by gift or transfer in trust on or before December 31, 1920, the basis shall be the fair market value of such property at the time of such acquisition.

* * * * * * *

(8) *Property acquired by issuance of stock or as paid-in surplus.*—If the property was acquired after December 31, 1920, by a corporation—

* * * * * * *

(B) as paid-in surplus or as a contribution to capital, then the basis shall be the same as it would be in the hands of the transferor, * * *

* * * * * * *

(b) *Adjusted Basis.*—The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis determined under subsection (a), adjusted as hereinafter provided.

(1) *General rule.*—Proper adjustment in respect of the property shall in all cases be made—

(A) for expenditures, receipts, losses, or other items, properly chargeable to capital account, including taxes and other carrying charges on unimproved and unproductive real property, but no such adjustment shall be made for taxes or other carrying charges for which deductions have been taken by the taxpayer in determining net income for the taxable year or prior taxable years;

* * * * * * *

SEC. 114. BASIS FOR DEPRECIATION AND DEPLETION.

(a) *Basis for Depreciation.*—The basis upon which exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be the adjusted basis provided in section 113 (b) for the purpose

of determining the gain upon the sale or other disposition of such property.

Treasury Regulations 94, promulgated under the Revenue Act of 1936:

ART. 23 (l)–1. *Depreciation.*—A reasonable allowance for the exhaustion, wear and tear, and obsolescence of property used in the trade or business may be deducted from gross income. For convenience such an allowance will usually be referred to as depreciation, excluding from the term any idea of a mere reduction in market value not resulting from exhaustion, wear and tear, or obsolescence. The proper allowance for such depreciation of any property used in the trade or business is that amount which should be set aside for the taxable year in accordance with a reasonably consistent plan (not necessarily at a uniform rate), whereby the aggregate of the amounts so set aside, plus the salvage value, will, at the end of the useful life of the property in the business, equal the cost or other basis of the property determined in accordance with section 113. * * *.

ART. 113 (a) (8)–1. *Property acquired by a corporation after December 31, 1920.*— * * *

In respect of property acquired by a corporation after December 31, 1920, from a shareholder as paid-in surplus, or from any person as a contribution to capital, the basis of the property in the hands of the corporation is the basis which the property would have had in the hands of the transferor if the transfer had not been made. * * *

U. S. GOVERNMENT PRINTING OFFICE: 1943

SUPREME COURT OF THE UNITED STATES.

No. 675.—October Term, 1942.

The Detroit Edison Company, vs. Commissioner of Internal Revenue.	On Writ of Certiorari to the United States Circuit Court of Appeals for the Sixth Circuit.

[May 3, 1943.]

Mr. Justice Jackson delivered the opinion of the Court.

The petitioner, The Detroit Edison Company, engages in the generation of electric energy and its distribution to the public in and near Detroit. It receives many applications for service which in its opinion would require an investment in extension of its facilities greater than prospective revenues therefrom would warrant. In such cases it undertakes to render the service if the applicant will pay the estimated cost of the necessary construction. This is done by contract of which there are five variations, some of which provide for refunds of part of the customers' cost if additional customers come in to share it, or if revenues exceed estimates. With these provisions we are not concerned, since the controversy here relates only to payments that never were, or which by the contracts have ceased to be, refundable. The amounts of the customers' payments are fixed by an estimate of the cost; they never exceed, and sometimes fall short of actual cost, but are not adjusted because of the difference between estimates and realization.

The Company constructs the facilities which become its property, and adds the full cost to its appropriate property accounts without deduction for the customer payment. It claims as a base for computing its depreciation the investment for which the Company is then reimbursed. Customers' payments are not appropriated to the particular construction nor earmarked for it, but go into the Company's general working funds. During the period that a payment is subject to refund it is carried in a suspense account; but if it is not subject to refund, or when the refund period is past, the ungefunded and unrefundable balances are

transferred to surplus through an account designated as "Contributions for Extensions."

During 1936 and 1937, the years in question, the Company added to its surplus from such sources $36,065.81 and $47,500.67 respectively. The Commissioner eliminated from the depreciable property of the Company that portion of the cost equivalent to the unrefunded and unrefundable balances of the deposits. These eliminations, amounting to upwards of $1,160,000 in each year, resulted in disallowing depreciation deductions from income of $40,273.11 for 1936 and $41,786.26 for 1937, and in deficiencies which the Company contested. The Board of Tax Appeals sustained the Commissioner and the Circuit Court of Appeals affirmed.[1] Because the decision appeared to conflict with principles followed in another circuit,[2] we granted certiorari.

A deduction from gross income on account of depreciation is permitted by § 23(l) of the applicable Revenue Act in these terms: "A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence."[3] For the basis we are referred by § 23(n) to § 114 of the Act which refers us again to § 113(b) thereof which provides an "adjusted basis" for gain or loss but which again refers us to § 113(a) for the basis upon which adjustment is to be made. The sum of these is that the basis of depreciation allowance "shall be the cost of such property" [§ 113(a)] making "proper adjustment" in respect of the property "for expenditures, receipts, losses, or other items, properly chargeable to capital account," [§ 113(b)(1)(A)] except in case of certain gifts; transfers as paid-in surplus, or contributions to capital [§ 113(a)(2), (8)(B)], which exceptions we will later consider.

It will be seen that the rule applicable to most business property of a cost basis properly adjusted leaves many problems of depreciation accounting to be answered by sound and fair tax administration. The end and purpose of it all is to approximate and reflect the financial consequences to the taxpayer of the subtle effects of time and use on the value of his capital assets. For this purpose it is sound accounting practice annually to accrue as to

[1] 45 B. T. A. 358; 131 F. 2d 619.

[2] Arundel-Brooks Concrete Corp. v. Commissioner, 129 F. 2d 762 (C. C. A. 4th).

[3] Revenue Act of 1936, 49 Stat. 1648.

each classification of depreciable property an amount which at the time it is retired will with its salvage value replace the original investment therein. Or as a layman might put it, the machine in its life time must pay for itself before it can be said to pay anything to its owner. Experience and judgment hit upon usable mortality tables for classes of property from which annual rates of accrual are estimated and several different methods are employed for relating this physical deterioration and functional obsolescence to financial statements. The calculation is influenced by too many variables to be standardized for differing enterprises, assets, conditions, or methods of business. The Congress wisely refrained from formalizing its methods and we prescribe no overall rules.

But we think the statutory provision that the "basis of property shall be the cost of such property" [§ 113(a)] normally means, and that in this case the Commissioner was justified in applying it to mean, cost to the taxpayer. A property may have a cost history quite different from its cost to the taxpayer. It may have been purchased for less or more than original cost, or built by contract which called for payments on which the builder profited greatly or suffered heavy loss. But generally and in this case the Commissioner was in no error in ruling that the taxpayer's outlay is the measure of his recoupment through depreciation accruals.

If this were otherwise in doubt it would be made clear by the provisions for "proper adjustment" of cost for receipts properly chargeable to capital account found in § 113(b)(1)(A). The customer payments so far as in question found their way into the Company's capital accounts by way of an addition to surplus. Their interdependency with the increases in property accounts caused by the construction they induced justified the Commissioner in relating the one to the other for the purpose of adjusting the basis for depreciation.

The Company, however, seeks to avoid this result by the contention that what it has obtained are gifts to it or contributions to its capital of the property paid for by the customer, and that therefore by the provisions of § 113(a)(2) and (8)(B) it takes the basis of the donor or transferor. It is enough to say that it overtaxes imagination to regard the farmers and other customers who furnished these funds as makers either of donations or contributions to the Company. The transaction neither in form nor in substance bore such a semblance.

The payments were to the customer the price of the service. The receipts have gone, so far as here involved, to add to the Company's surplus. They have not been taxed as income, presumably because it has been thought to be precluded by this Court's decisions in *Edwards* v. *Cuba R. Co.*, 268 U. S. 628, holding that under the circumstances of that case a government subsidy to induce railroad construction was not income. But it does not follow that the Company must be permitted to recoup through untaxed depreciation accruals on investment it has refused to make. The Commissioner was warranted in adjusting the depreciation base to represent the taxpayer's net investment. Nothing in the Regulations is to the contrary and nothing in *Helvering* v. *American Dental Company* (No. 303, decided March 1, 1943) — U. S. —, when read in the context of its facts touches this problem at all.

Affirmed.

The CHIEF JUSTICE did not participate in the consideration or decision of this case.

A true copy

Test:

Clerk, Supreme Court, U. S.